



Telecom New Zealand Limited

**Submissions on the
Telecommunications Amendment Bill**

15 August 2006

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A EXECUTIVE SUMMARY

1 The Telecommunications Amendment Bill will make significant changes to the approach of telecommunications regulation in New Zealand. This is a critical time for the industry. It faces challenges of both technology and expectations. It requires investment and innovation. Striking the right balance is not easy. We welcome the opportunity to discuss the future with the Select Committee.

2 We are committed to working with the new approach to regulation. We have already announced a series of changes in response to the Government's stocktake, including the decision to move to operational separation. This submission explains how the planned operational separation will work and makes suggestions for amendments to the Bill which we believe align with the Government's objectives.

Operational separation

3 Operational separation means a separation of the wholesale and retail parts of Telecom. This will result in a significant shift in the way we do business. When delivering wholesale access services, we will put wholesale customers on the same footing as our retail business units. The core features of the model are:

- committing to the principle of non-discrimination in the delivery of targeted access services (identified in the Glossary to this submission);
- making this commitment in permanent legally binding and detailed undertakings on price, products, processes and timing. We will commit to timing in relation to the current network and the Next Generation Network;
- our performance against the undertakings will be monitored by an independent oversight group;
- there will be audit and reporting of our performance against the undertakings;
- separate incentives for our wholesale staff;
- a high degree of transparency and information sharing with our wholesale customers.

4 The model is designed to facilitate a level playing field for the provision of targeted access services, as quickly as is practically possible.

5 There are a number of ways to deliver the outcomes the Government is looking for. We have studied all of these. In deciding on operational

separation as the preferred way forward we have sought to balance a number of tensions, including the size of the NZ market, the needs of customers, the desire for more competition, and the need to retain incentives for investment. We are acutely conscious of the trade offs involved in choosing where to focus our people and resources. Implementing structural separation, or re-engineering current systems when the NGN network is expected to be in place two years from now, will prevent us from meeting the government and public expectations on the roll out of these new technologies.

- 6 We can not deliver what New Zealanders now expect if planning has to go on hold. Opportunities for the industry, as well as our business, will be lost. Staff, customers and shareholders must know where we are heading. Uncertainty undermines internal morale, it means that customers can't plan and it makes it harder to finance investment. Irreplaceable staff will be poached to go overseas.
- 7 The Government has signalled we should consider some form of separation. The Select Committee will evaluate the arguments.
- 8 We have already embarked on a process of operational separation. We have done this because we needed to move swiftly to give both the industry and our shareholders some clarity about our future direction, and because we believe operational separation is the most effective model to deliver the competition and transparency being sought.
- 9 This commitment to enter into binding undertakings is a significant step. It will level the playing field for wholesale customers purchasing targeted access services, and ensure that this occurs in a workable and timely way. It is designed to have bite. The Independent Oversight Group will monitor our behaviour. If we fail to live up to our undertakings on separation we will be publicly held to account. Issues which may arise around the workability of enforced separation options can be avoided and the timeframe for achieving separation is much faster for operational separation than structural separation.
- 10 Operational separation requires us to significantly change the way we do business. It will enforce a cultural and behavioural change on us that will require Telecom to be more open and transparent.
- 11 Our board and executive are committed to operational separation, and we are four months into our organisational change programme on the basis that Telecom Wholesale is separate from Telecom Retail. We are confident that we can put a permanent form of operational separation in place in a timely manner.

- 12 Attached as **Appendix A** is a table comparing the BT operational separation undertakings with our proposed undertakings. Attached as **Appendix B** is an explanation of our planned operational separation in "Question and Answer" format. We would be happy to provide further detail. We propose to enter into a very similar regime. There are some differences. We are intending to take a different transition path, and the reasons - essentially scale, cost, and timing - are discussed fully in this submission.
- 13 We have looked at the BT experience closely. There, it will take more than five years for the company to deliver on its undertakings. We want a more speedy solution because we believe that is what New Zealand wants, and because with a solution comes certainty and that is what our shareholders are seeking.
- 14 The Bill seeks to transform the telecommunications sector by broadening the scope of regulated wholesale designated access services, introducing LLU and significantly increasing the role and scope of regulation.
- 15 The Bill's proposed remedy is accounting separation. We disagree with this. Accounting separation is simply regulatory accounts and information disclosure. We believe our planned operational separation goes much further than that.
- 16 Because operational separation divides Wholesale and Retail it will require Wholesale to do separate management accounts. These will be available to the Independent Oversight Group.
- 17 If at any time the government is not satisfied by this arrangement a form of accounting separation can be introduced. We support it being held in reserve, in this way. Regulating now for accounting separation would prove to be a costly, complex and protracted process.
- 18 The Minister, the regulator and the industry should be given the time to assess the performance of operational separation before it is diverted into some more narrowly focused model.
- 19 We believe operational separation, combined with some aspects of the Bill, will achieve the objectives sought. The Bill by itself, or the extreme option of structural separation, will not. We outline why in Section B of this submission.
- 20 Should the Committee decide to retain the Bill's proposed remedy of accounting separation we have a number of suggestions aimed at improving the workability of that model. See **Appendices C** and **D**.

- 21 Getting the future structural arrangements right is a crucial ingredient in ensuring New Zealanders get access to world class technology. But it is not the only ingredient.

Greater investment by industry players

- 22 The changes proposed by the Bill mean that industry participants may have a number of regulatory options in any one market. This means that if the Commerce Commission does not get the pricing and competition analysis right, one form of regulated access may be artificially attractive. This could distort the nature of competition in the market, and investment levels by industry participants. This will be a central challenge for the Commission going forward.

- 23 We submit the Commission should be required to consider the relativity of pricing between *all* relevant regulated services when setting regulated prices (at present it must consider only two), and be required to consider the state of competition when considering an application for LLU.

- 24 We also submit the Commission should be required to regularly review the availability of regulated services. Where a market is competitive, or a regulated service has been eclipsed by competition from industry participants using a “deeper” form of regulated access (where a competitor uses more of its own infrastructure), there is no sense in continuing to make the shallower form of regulated access available. The ultimate objective of the regime is to facilitate industry participants who want to move from reliance on regulation to investment in infrastructure. This approach is in line with best regulatory practice overseas.

The Commission’s processes

- 25 We are proposing ways in which the standard terms and other related determination processes can be simplified. The Bill would require the Commission to determine all of the terms in the “standard terms” contract up front. Currently the Commission usually only adjudicates on price, and even then concerns about delay have been raised. To require all terms of the regulatory contract to be adjudicated up front will significantly delay access to regulated services. We propose a process similar to that in the UK, which allows wholesale customers to get into the market quicker and refine terms and conditions after that.

- 26 We recommend that industry participants affected by a Commerce Commission decision should be allowed to seek a review on the merits. The Bill provides for a much more active role by the Commission. All industry participants are being encouraged to invest, and all of us have an interest in some long term quality checks to help ensure that New Zealand has robust and high quality regulatory outcomes. With the best intentions, increased regulation brings with it increased risk of regulatory error.

- 27 This is recognised in other jurisdictions. Safeguards can be put in place to mitigate any concerns as to delay – in particular, regulatory decisions should stand notwithstanding an appeal unless there are exceptional circumstances. Merits review is a good investment – the investment in time and the right itself is compensated for in quality, certainty and clarity.
- 28 The remainder of this submission discusses these proposals. Our suggestions for minor improvements and drafting changes to the Bill are set out in **Appendix D** to this submission. The changes proposed are designed to enhance the new regime, not detract from what the Bill is trying to achieve. The changes follow five key themes:
- regulatory certainty;
 - good regulatory practice;
 - procedural fairness/consultation;
 - protection of customer confidential information/information disclosure;
and
 - enforcement.

RECOMMENDATIONS

In summary, Telecom brings the following key recommendations to the Select Committee's attention:

A level playing field for access services

Note in its report:

- An operational separation model which maintains Telecom as a single entity but with separate retail and wholesale divisions within Telecom could achieve the government's objectives.
- The operational separation model put forward by Telecom represents a workable balance between the objectives of balancing investment incentives and providing for a level playing field for the provision of access services (as discussed in section B).
- A process for finalising the detail and implementation of Telecom's operational separation is needed, including finalisation of formal undertakings with the Crown. This process should be public and its conclusion binding.

Consider whether, in light of Telecom's operational separation plan, accounting separation is necessary, or should be made discretionary.

Amend the Bill to provide that the accounting separation regime is to be brought into force by regulation, rather than being mandatory.

Amend the Bill to provide that, if the accounting separation regime is brought into force, it must be consistent with any operational separation agreed with the Crown. More specifically, Telecom proposes amending the Bill to require that any regulations made by the Minister, and thus also the rules made by the Commerce Commission, for the regime must be:

"consistent with any operational separation of Telecom's wholesale and retail business activities agreed between Telecom and the Crown." (this is our proposed section 69D(2)(c) in Appendix C).

Amend the Bill requiring that any such regulations relate only to the wholesale access services that are the subject of any agreement between Telecom and the Crown for operational separation.

Greater investment by industry players

Pricing relativities

Amend the Bill to ensure that the Commerce Commission has regard to the relativity of pricing between regulated resale, forms of UBS, LLU and network competition. The proposed UBS service description currently requires:

The Commission must consider relativity between this service and Telecom's unbundled copper local loop network service.

Telecom proposes the service descriptions for resale services, unconstrained UBS and LLU be amended to require:

The Commission must consider relativity between resale services, Telecom's unbundled bitstream access, (and related back haul), Telecom's unbundled copper local loop network services (including related co-location and back haul services), and the cost of competing network access services.

Competition test for regulation

Amend the Bill to include a competition test in the LLU and LLU backhaul (distribution cabinet to telephone exchange) service descriptions. Telecom proposes the same test as used in other service descriptions already in the Act, vis the following condition:

That either –

- (a) Telecom faces limited, or is likely to face lessened, competition in a relevant market; or
- (b) Telecom does not face limited, or is not likely to face lessened, competition in a relevant market, and the Commission has decided to require Telecom's unbundled copper local loop network service to be wholesaled in that market (i.e. where the Commission has decided that regulation is nevertheless required).

Regulation with no expiry date

Amend the Bill to require the Commerce Commission to carry out regular reviews of any determination or decision that does not have an expiry date, to assess whether such regulation should remain in force or should be amended. Telecom proposes a new section 19B requiring the Commission to regularly review:

Any determination or decision that does not have an expiry date to assess whether the determination or decision should be amended to reflect:

- whether the applicable conditions for that regulated service are still met, in particular the assessment of the state of competition in the relevant market;
- Whether the section 18 purpose continues to be best met by the determination or decision.

Regular review of regulation

Amend the Bill to include a provision requiring the Commission to regularly review existing regulation to assess whether shallower forms of access should continue to be available or should be removed (using the processes in Schedule 3 of the Act to conduct the review).

Amend the Bill to emphasise targeted regulation by including a new section 19(d) that states:

19(d) the recommendation, determination or decision is the minimum necessary that best gives, or likely to best give, effect to the purpose set out in section 18.

The Commission's processes and ensuring high quality regulatory decision making

Amend the provisions relating to the standard terms process to reflect the process improvements discussed in this submission.

Amend the Bill to provide for an ability by those affected by a decision of the Commerce Commission to seek merit review, in line with overseas best regulatory practice.

B A LEVEL PLAYING FIELD

29 A key issue is a level playing field for our wholesale customers. On 4 August we publicly committed to making a level playing field happen through a substantive move to operational separation.

30 We launched a Wholesale Charter in April. The Charter contains three principles that Telecom Wholesale works to, including continuous service improvement. Work and engagement within Telecom is well underway with reporting on consistency in service delivery for wholesale customers and Telecom retail having been delivered on 31 July.

Operational separation

31 Our plans for separation are based on the BT separation, with some changes appropriate for the New Zealand environment. There are three principal foundations for our operational separation: creation of a separate wholesale division, public and binding undertakings to deliver targeted access services on a non-discriminatory basis, and independent monitoring.

32 Our plans include the following key features:

32.1 Commitment to non-discrimination between wholesale customers and Telecom Retail when using targeted access services;

32.2 Separation of the wholesale unit from the retail units to deliver on this commitment, including:

(a) Separate incentives for the wholesale business; and

(b) Restricted information flows between Wholesale and Retail, and separate physical premises;

32.3 An Independent Oversight Group to monitor and report against undertakings;

32.4 Audited review and reporting of our performance against undertakings.

Our commitment to non-discrimination

33 We are proposing to commit to non-discrimination by entering into undertakings negotiated between Telecom and the Crown. BT committed to a similar set of undertakings. The undertakings would commit us to "equivalence" for the delivery of targeted access services on the following basis:

- 33.1 The delivery of NGN targeted access services will be at the same price, consist of the same products and involve the same processes for wholesale customers and Telecom Retail (*equivalence of inputs*);
- 33.2 For new targeted access services introduced prior to next generation services delivered over the NGN we will deliver as close to the equivalence of inputs standard as possible (recognising there may be some constraints because of legacy systems); and
- 33.3 When delivering current regulated services we will ensure that the wholesale customer gets the same or substantially similar products and processes as Telecom Retail (*equivalence of outcomes*).
- 34 The aim of equivalence is to remove any discrimination or appearance of discrimination between our wholesale customers and Telecom Retail. There are two measures of this; equivalence of inputs and equivalence of outputs.
- 35 *Equivalence of inputs* means that wholesale customers and Telecom Retail receive from Telecom Wholesale the same product or service, on the same timeframes, terms and conditions, and using the same systems. It also means Telecom Wholesale will provide the same commercial information about products, services, systems and processes. Everyone gets exactly the same deal.
- 36 We are committing to deliver this level of equivalence on all targeted access services on the Next Generation Network (NGN), and as close as possible to this standard for all new targeted access services introduced before then. This means, for example, all new broadband targeted access services will be delivered as close as possible on an EOI basis.
- 37 BT has a detailed timetable where it phases EOI in between now and 2010 for PSTN (or legacy) wholesale products. BT has not set a date for delivering access services on the NGN on an EOI basis. We will take a significant step further than BT by committing to a timeframe for the delivery of the NGN and EOI commitments on all NGN targeted access services. Our undertakings will include detailed timelines.
- 38 In the transition period prior to the NGN we will be progressively committing to delivering all current regulated wholesale products on an *equivalence of outcomes* basis. Equivalence of outcomes means that wholesale customers get substantially the same outcome as Telecom Retail. There may be different IT systems used, for example, but the actual end result will be substantially similar.
- 39 Before we could commit to “delivering to wholesale customers and Telecom Retail using the same systems”, we would need to re-engineer our current systems. This could be done, but there are some significant trade-offs.

- 40 If we were to commit to equivalence of inputs for current wholesale products we would need to redesign and rebuild most of our current systems. To put this into context, Telecom is a vertically integrated company with over 900 applications which are all tightly linked. In the process of providing a customer with a basic residential line over 100 different applications are engaged. For just this one product, re-engineering our systems to provide for equivalence of inputs would be extremely complex, time consuming and expensive. We have thousands of such products.
- 41 However the far greater strategic concern is that trying to achieve equivalence of inputs across the board would tie up technical resources and compromise our ability to offer new services based on NGN technology. We are currently competing in an international market for the resources and people needed to roll out the NGN (against the likes of Telstra), and this is already a constraint. Those same resources would need to be diverted to re-engineer current processes, and to do so would significantly delay the roll out of NGN services.
- 42 One of the principal drivers of the decision to mandate unbundling was the desire to speed up New Zealanders' access to world class broadband. We do not want to see the money and skills required to introduce the newer technologies diverted into rebuilding the current systems, when the services they deliver will rapidly become obsolete.

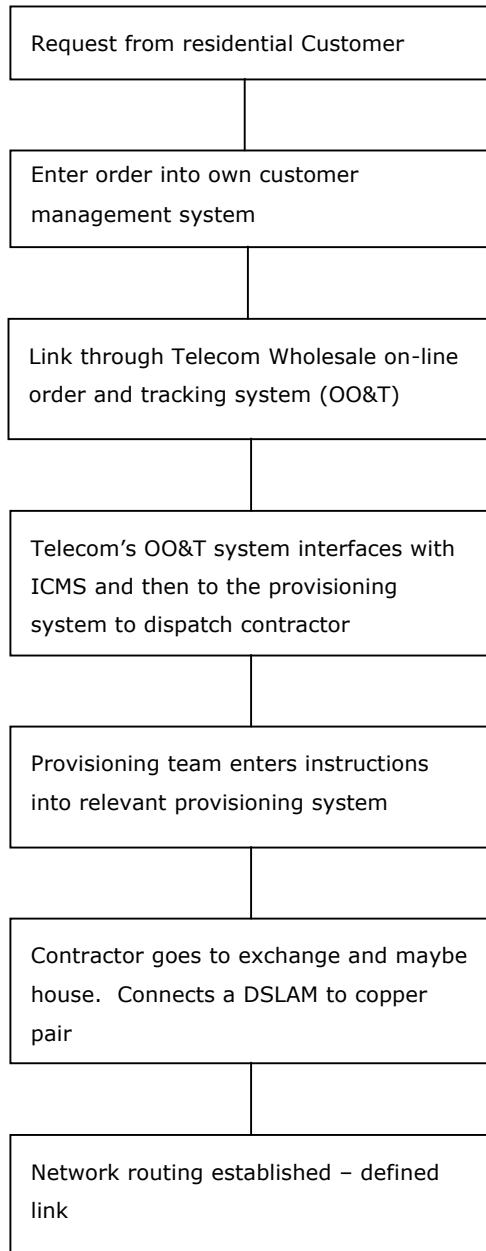
An example

- 43 To illustrate the practical complexities involved we have used the example of UBS.

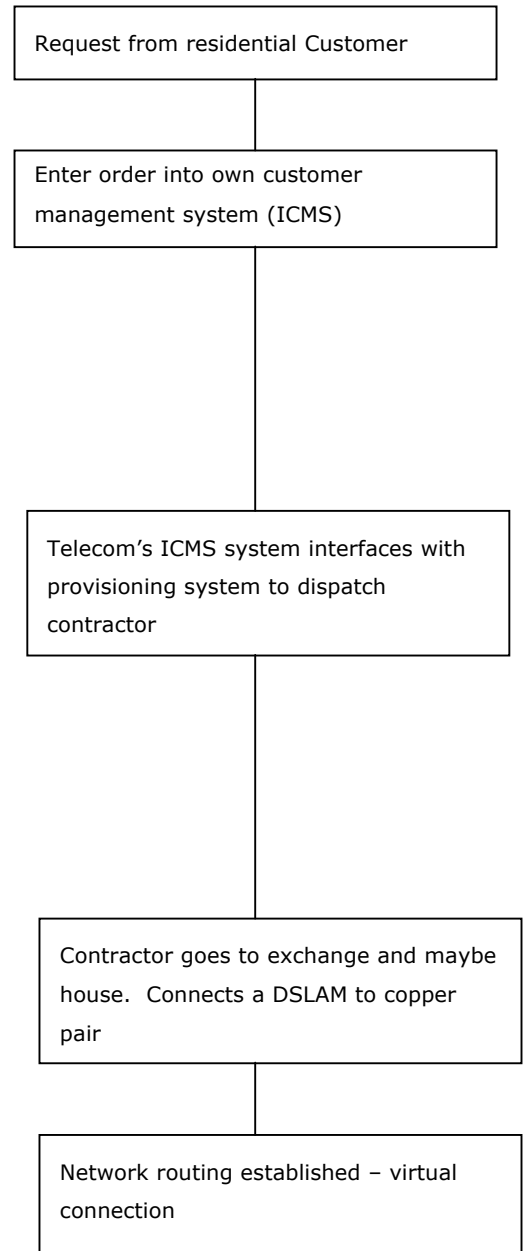
UBS – the "EOO" standard

- 44 We are already delivering UBS to wholesale customers on an EOO standard (i.e. a wholesale customer and Telecom Retail get substantially the same outcome, but different systems are used). The diagram below illustrates what is involved.

Wholesale Customer



Telecom Retail



- 45 The first difference is that our retail customer management system is integrated, whereas linking to a wholesale customer involves additional steps. We address this by streamlining the wholesale processes as much as possible and providing additional systems and automation to provide wholesale customers with equivalent access to the extent possible. This way, the timing is non-discriminatory for most transactions.
- 46 The second difference is that the network service is different. In other words, the product sold to the wholesale customer differs from that used by Telecom Retail although it has been designed to deliver the same outcome. Wholesale customers asked for this difference – it gives them the capability to control more of what the customer can do, and means the wholesale customer can create differentiated retail services (e.g. a 7GB broadband plan instead of 5 or 10).
- 47 The third difference is Telecom Retail does not pay a transfer price. However, the price paid by the wholesale customer is set by the regulator for regulated UBS.

UBS – transition to EOI

- 48 Between now and when UBS services are made available on a full EOI basis, we intend to make some transitional changes. Most significantly, Telecom Wholesale will take the lead on new product development, after consulting all of its customers.

UBS – EOI

- 49 When our NGN is in place Telecom Wholesale will service wholesale customers and Telecom Retail using the same systems, products and prices.

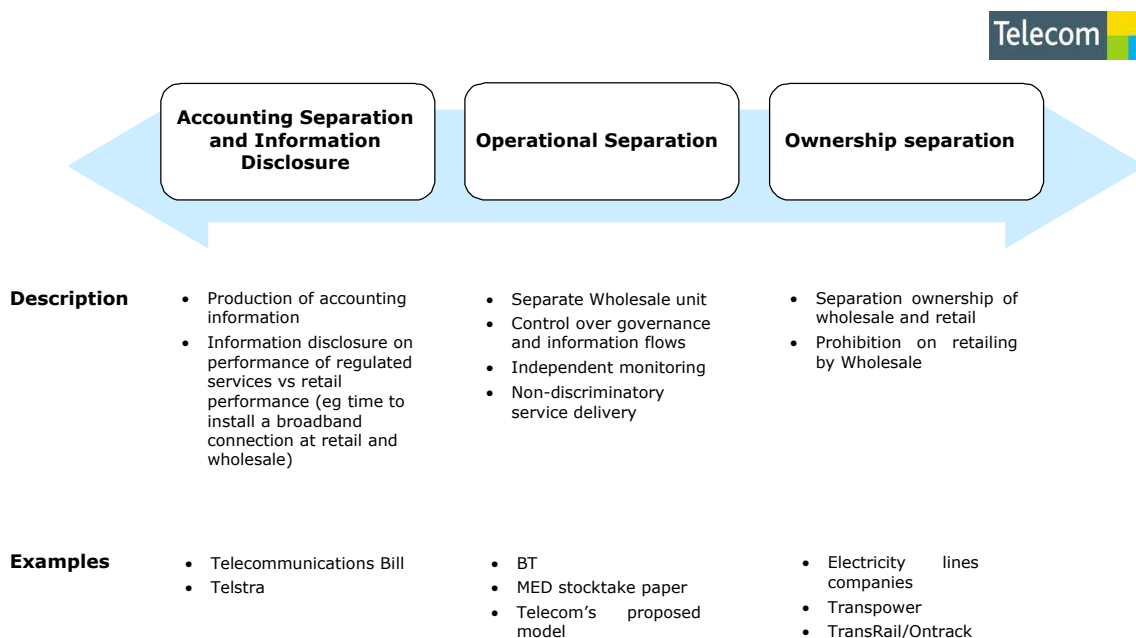
Comparison with the UK and BT

- 50 Our operational separation proposal could be best described as the BT model but tailored to the much smaller NZ market and the Government's policy objectives. The key differences to the BT model appear in **Appendix A.**
- 51 The BT model has a great deal to recommend it, but transplanting it unmodified to the New Zealand market would be problematic. For example, BT has estimated the one-off capital cost of the transition to its new operating model to be £70 million (NZ\$210 million), and we expect a similar magnitude of cost were we to transplant the exact same model into our business.
- 52 For a company of BT's size, £70 million represents just over 2% of their 2006 capex, but for Telecom, this quantum of capital cost would represent over 25% of our entire annual capex budget and result in critical delays to the introduction of the next generation of technology to New Zealand.

Where we have identified issues such as this, we have proposed workarounds which deliver the same or substantially similar outcome as BT's model, but which avoid the crippling costs associated with it.

Other forms of separation

53 The Minister has invited interested parties to make submissions on Telecom's organisational structure to the Select Committee. There are a number of separation options. These run along a spectrum from accounting separation to structural/ownership separation:



54 Put simply:

- **Accounting separation** is simply disclosure of regulatory accounts and information. This is the least intrusive form of separation, based on the principle that provision of information enables effective monitoring of Telecom.
- **Operational separation** is more interventionist. It means Telecom retains ownership of both its network and retail businesses, but with clear rules around how the two parts of the business interact, and how bottleneck services must be delivered and managed. It also requires disclosure of information to enable effective monitoring.
- **Structural or ownership separation** is the most radical. It means splitting Telecom into two separate companies, with separate CEOs and separate boards. One for the network, one for the retail businesses.

Accounting separation

- 55 Overseas experience suggests that accounting separation is usually introduced first as an interim measure. It tends to require protracted implementation and produce outcomes that may be of limited practical benefit for the industry.
- 56 We want to avoid any transition phase in the restructuring of the company and the telecommunications environment. For this reason we have already leap-frogged beyond accounting separation in our own planning.
- 57 We therefore submit the accounting separation regime should be discretionary not mandatory, support any wholesale/retail separation agreed between the Crown and Telecom, and focused on targeted access services.
- 58 We submit the Bill should be amended so that the accounting regime can be brought into force by regulation, rather than being mandatory (for example, as occurs in all EU regulation). We believe our separation proposal, which includes auditing, reporting, and independent oversight, will be more useful than an accounting separation regime. Before Telecom and the Commerce Commission incur the expense of an accounting separation regime, we believe the Crown should wait to assess the benefits of operational separation. The Bill can provide for accounting separation to be implemented when needed.
- 59 We also propose that any accounting separation regime be consistent with any operational separation commitments agreed to between Telecom and the Crown. In other words, the separation for accounting purposes (eg: as between retail and wholesale) should support and work in parallel with, the proposed operational undertakings, the end goal of which is to deliver on our commitment to non-discrimination. There are two reasons for this. First, it will improve the utility of the accounting regime. The accounting regime will provide a regulatory check and transparency on the delivery of targeted access services, and whether we are delivering on our undertakings. Operational separation and accounting separation should act as a coherent package. Second, if a different definition of "retail" and "wholesale" is used, the process will become a costly and confusing white elephant. How will anyone make sense of us operating on one basis, and reporting on another?
- 60 For similar reasons, we think any accounting separation should be extended to cover targeted access services only. The scope of any accounting separation should mirror the scope of our operational separation. Accounting separation would then work with the undertakings, with Telecom accounting for transactions under the accounting separation regime that demonstrate our conduct is in line with the commitments on targeted access services made in the undertakings.

61 We note that the broader information disclosure regime (as opposed to the accounting separation regime) would still apply to all access providers, including Telecom, and would relate to all regulated services.

Improving the design of the regime

62 We also make suggestions in **Appendix D** aimed at improving the effectiveness and workability of any accounting separation regime. Some of these suggestions include amending the Bill to:

62.1 include statutory criteria and principles to guide the Commission's discretion to determine the detailed rules and methodologies for accounting separation;

62.2 require Regulations to provide more detailed and technical guidance for the exercise of the Commission's discretion;

62.3 require the Commission to publish Rules prescribing its requirements, before Telecom and other access providers are to produce separated accounts, following a consultation process established by the Act;

62.4 establish procedural safeguards for disclosure of commercially sensitive information and safeguards for a reasonably practicable implementation timetable; and

62.5 reduce the proposed penalty from \$1 million to \$250,000.

63 The reasons for making these changes are set out in the attached **Appendix C**.

Structural or ownership separation

64 Both the OECD and the MED share the view that there are material risks involved with implementing structural separation. The MED in its 28 April 2006 Stock-take paper concluded: "In view of the likely costs relative to the benefits in a small market like New Zealand, ownership or operational separation may not be the preferred solution where behavioural modifications can be achieved by less intrusive interventions".

65 The OECD has consistently expressed caution about structural separation. In the course of the Telecommunications Stock take review, the OECD advised officials that it did not believe the benefits of full structural separation outweigh the associated costs¹. This essentially reiterated the OECD's views that²:

65.1 Vertical separation is a significant intervention in the marketplace, with substantial and – unlike behavioural regulation which can be reversed – irreversible costs. It should not be undertaken lightly. Seemingly simple in concept, structural separation of the local loop is in practice complex with uncertain outcomes and many questions to be answered. The benefits of structural separation of the local loop are uncertain while the costs are certain and appear potentially large. There is little evidence that the benefits of structural separation of the local loop are sufficiently in excess of costs. (From conclusion in OECD's 2003 report on structural separation of the local loop.)

66 The EU also shares this view. It notes, in commenting on regulatory options for electronic communications networks and services, that³:

The general view, as confirmed by two OECD reports [footnote 17], is that complete structural separation is rarely justified in the communications sector. Overall, the costs of structural separation appear to be greater than the expected benefits, in particular due to the fact that even after structural separation, regulation of the independent local loop operator remains necessary to prevent monopoly pricing. Other disadvantages concern the adequate level of investment in network infrastructure when providers do not receive the revenues and consequent incentives that flow from vertical integration. Experience in other sectors (e.g. railways) has shown the problems of co-ordinating investment when infrastructure and services are separated. This problem is more acute in the communications industry, where technological change is rapid and where investment demands are pressing.

67 We agree that structural separation is unlikely to achieve the Crown's objectives of maintaining investment and innovation incentives, and achieving a high performing telecommunications industry. It is more likely to result in increased end-user prices and poor customer service. Splitting

¹ cable date 30 March 2006, released as part of the Stocktake papers.

² <http://www.oecd.org/dataoecd/39/63/18518340.pdf>

³ See "Impact Assessment", page 11, at http://ec.europa.eu/information_society/policy/ecomms/doc/into_cent_re_public_consult/review/impactassessment_final.pdf

assets and managing them in isolation puts end service at risk with no one responsible for end to end performance.

68 Structural separation has been imposed on a number of network industries in New Zealand. Examples include:

68.1 The separation of Transpower from ECNZ.

68.2 The separation of electricity supply companies into retail and network lines businesses.

68.3 The separation of the rail industry into Ontrack (the network) and TransRail (the exclusive retail marketer of rail services over the network).

69 There are some key lessons to be taken from these examples:

69.1 *Investment incentives* - significant issues with investment incentives arise when a company is split. These issues are apparent from both the Transpower and rail network examples.

69.2 *Significant operational costs and complexity* - the costs of creating separate operating systems will be substantial. These costs would take money away from the pool available for investment and innovation, and are likely to result in a rise in consumer prices. In the electricity market, such price increases have been significant.

69.3 *Customer service issues* - there is a significant risk of operational complexity leading to customer service issues. In the electricity sector, the well publicised problems with billing, and who was accountable for end-to-end customer service for issues such as fault management, took years to resolve.

69.4 *On-going public concern* - in all three cases the New Zealand public remains unconvinced of the benefits, years after separation, and little political consensus exists about the way forward.

Impact on investment

70 A key Government objective is to maintain investment in the industry. This is particularly important if New Zealanders are to have access to world class telecommunications technology. While we agree with the Government that the onus should be on all industry participants to invest, investment by Telecom will be an important part of creating the telecommunications sector the country is aiming for.

- 71 Structural separation would make it harder for us to make major investments. This is because:
- 71.1 Our investments are very large.
 - 71.2 Our demand side risks are large and increasing.
 - 71.3 Many of our wholesale customers have little capital to spend on risk.
- 72 We spend billions, not millions. The network assets have a very long-term life and, to achieve scale economies, involve commitments to large fixed costs. We can afford to make these investments because at present our retail arm is an anchor customer. As with other large scale risky projects, the presence of an anchor customer significantly reduces the challenge of such projects.
- 73 By making investment decisions in concert with our marketing division we are able to be more bold about how much money we spend and on what. Marketing has the expertise to understand, predict and develop consumer behaviour. This is crucial. It allows us to invest in options that have very high fixed costs because the marketing side of the company knows it can develop consumer demand and high take-up, which in turn gives us the necessary return on investment.
- 74 In introducing a technology like IPTV, for example, we are entering an already concentrated market and competing with established infrastructure players such as SKY and BCL. The cost of developing that technology is very high, and we need the expertise of and integration with our marketing division to justify the commitment, since it will be marketing who assembles the content that will ultimately attract consumers to the technology. Without reliable projections from marketing there is no basis to make a large, risky investment.
- 75 Many of the newer services, like IPTV, require consumers to transition from old technology to new technology. Consumers don't make the move on cost alone, but because they have also been convinced of the increased value of the proposition. This means the success of any technology introduction relies on intimate knowledge of customer needs and much more than just network connectivity.
- 76 A structurally separated Telecom would see the infrastructure company forced to rely on its own assessment of market demand and the forward commitment of wholesale customers as the basis on which investment decisions were made. This is much less likely to result in large scale investments, because it is much more difficult to deliver the returns shareholders require. There is also a real risk that in this environment investment in infrastructure, and more sophisticated services, will skew

toward more densely populated urban areas and contribute to a digital divide in New Zealand.

- 77 Many of our wholesale customers are small entrepreneurial start-ups with little capital. They are not typically in a position to take on board a fair share of the risk of future network investments. (This is in itself the reason why a wholesale option is necessary.)
- 78 In summary, we submit there are significant downsides to structurally separating (or imposing an extreme form of operational separation with the same effect). This view is widely shared by policy makers in the OECD and EU.

The Committee's report

- 79 We have made a commitment to implement operational separation. We are open to feedback on our proposed model and proposals for change.
- 80 Like the Government, we have looked to the UK for a blue-print. In the UK, BT negotiated a set of legally enforceable undertakings focused on "creating a climate of confidence for infrastructure competition, investment and innovation". As part of Telecom's commitment to work with the new regime we have made public our proposal to operationally separate. We want to work with the Crown to finalise our undertakings, and would expect that any draft set of undertakings would be subject to public consultation before finalising the detail and implementation.
- 81 We believe this process will lead to a faster and more flexible solution than legislative intervention. That has certainly been the British experience. Similarly we believe that the British experience of a voluntary agreement approach offers far more positives. The Telecom team that recently visited BT was struck by the level of internal commitment. The key benefit of this was a real sense that BT could implement the undertakings in a timely way and really make them work within its organisation. Interestingly BT executives advised us that their approach reflected some issues particular to the UK, and advised us that it would be inappropriate to simply transplant their model.
- 82 We encourage the Committee to note in its report that the operational separation model we have put forward represents a workable balance between the objectives of balancing investment incentives and providing for a level playing field. A process for finalising the detail and implementation of our operational separation is needed. This process should provide for public consultation on the proposed agreed form of undertakings before finalisation.

C GREATER INVESTMENT BY INDUSTRY PLAYERS

83 A significant objective of the Bill is to increase the level of investment by all industry players. We endorse this objective.

New levels of wholesale access services: LLU, UBS and naked DSL

84 The Bill introduces three new types of wholesale access services - LLU, forms of UBS and naked DSL. These new regulatory options will allow our competitors to expand into a market using progressively more of their own equipment. The progression is from resale of Telecom's services at one end of the spectrum, through unconstrained UBS, naked DSL and LLU, to infrastructure competition at the other.

85 Clearly, having this range of regulatory options puts a premium on the Commission getting its relative wholesale pricing and competition analysis "right". If it does not, investment options (and investment levels) by our competitors will be distorted.

86 MED refers to this as the "ladder of investment". Of particular significance are the issues of (i) pricing relativities between the different levels of wholesale services on the "ladder of investment", and (ii) ensuring that regulation only occurs where necessary - that is, only where Telecom faces limited competition in the market.

87 The concept of a "ladder of investment" is referred to (and endorsed) in the Cabinet paper supporting the introduction of the Bill, as follows:

*[99] A commonly adopted approach in the EU and other jurisdictions that attempts to find a balance to increase overall investment levels is the so-called "**ladder of investment**" that drives wholesale competitors toward investment in their own infrastructure. Commencing at lower rungs of the ladder with basic resale and intermediate wholesale of services while building a customer base, this concept envisages movement via LLU to eventual investment in alternative network infrastructure. The long-run aim of such policies is competition on level terms among operators, and it is important to price wholesale access products appropriately so as to maintain incentives for progressive alternative infrastructure investment.*

[103] It is important to encourage investment and enable movement through time toward alternative infrastructure. The pricing relativities between these products should be carefully set by the Commission to maintain incentives for both Telecom and entrants to invest in infrastructure and service provision. The regulatory framework needs to be as stable as possible to encourage investment but specific settings such as pricing need to be flexible to respond to market developments.

[109] The Act will also be amended to ensure that, when applying the retail minus pricing principle, the Commission will also consider the price of the LLU service, if determined, and the relativity between the UBS and LLU prices. This will provide for a graduated approach enabling access seekers to migrate customers from UBS to LLU.

[111] Under a ladder of investment approach, naked DSL could be seen as a transitional provision. As access providers progressively take up LLU to provide a range of broadband services, the need for UBS, including naked DSL, would reduce and could ultimately be withdrawn.

- 88 The underlying assumption of the ladder of investment is that competition in infrastructure is more efficient and beneficial than competition based on resale of Telecom's retail services, and that regulation should actively and overtly encourage a progression "up the ladder", ultimately towards infrastructure-based competition where this is feasible.

Making the ladder of investment work

- 89 We believe that for the ladder of investment concept to work effectively (that is, to encourage participants to climb the ladder), three features are essential:

89.1 the price of each regulated service needs to take account of the price of all other regulated services;

89.2 the Commission should only regulate access to a service in markets where there is limited competition, (as is the case in other countries where the ladder of investment is taken into account); and

89.3 the Commission should regularly review whether each form of regulated access should be available in a market. First, where the Commission has issued "standard terms", which have no expiry date, the Commission should regularly review market conditions to check whether the standard term determination is appropriate. Second, if competition is occurring on the basis of deeper forms of access, such as LLU, or on the basis of competing networks, then the Commission should consider whether shallower forms of regulation such as resale should continue to be available under the Act.

- 90 The changes proposed by the Bill mean that industry participants may have a number of regulatory options in any one market. This means that if the Commerce Commission does not get the pricing and competition analysis right, one form of regulated access may be artificially attractive. This could distort the nature of competition in the market, and reduce investment levels by industry participants.

- 91 By not taking into account the other options or the other “rungs” on the ladder of investment when setting regulatory terms and prices, the Commission may create the incentive for entrants to collect on one rung on the ladder and not move up the ladder. This would defeat the objective of competitors investing in their own infrastructure.
- 92 There are four options available to competitors on which they can base their broadband services: these are (i) resale of Telecom’s broadband services, (ii) UBS or naked DSL, (iii) LLU, and (iv) building their own access network. Economists agree the form of competition where competitors ultimately build their own networks is the form that delivers the best outcomes for customers. In order to reach this outcome, as the Government stocktake implies, the resale, UBS and LLU options are rungs that competitors step onto and then step off as they climb towards investing in their own infrastructure. However, the risk is that the wholesale price and terms for access to these options will result in competitors stepping onto a rung, but not stepping off.
- 93 This could happen at each rung in the ladder. For instance, if the wholesale price for UBS is low relative to LLU then a competitor will not have the incentive to invest in the infrastructure necessary to offer services over LLU. As a result, competitors will stay on the UBS rung simply because it does not make commercial sense for them to step onto the LLU rung. Likewise, if the wholesale price of LLU is low relative to competitors building their own networks then competitors will stay on the LLU rung because they will not have the commercial incentives to build their own alternative access network.

Commission should consider all pricing relativities

- 94 At present, the service descriptions in the Bill only require the Commission to consider the relativity of pricing between LLU and UBS when setting LLU and UBS pricing. While this goes some way to ensuring that the Commission can determine whether the steps of the ladder available to access seekers are correctly priced, this leaves out relativity of pricing with both the bottom and top rungs on the ladder - the relativity considerations need to be across resale of retail services, UBS, LLU and the cost of a competing network.
- 95 Getting these relativities right is important to provide the correct price signals for a competitor’s decision to use regulated services or to invest in their own assets.
- 96 We also note that the existing requirement in the Bill, to consider the relativity between the regulated prices of LLU and UBS, is not a ‘like-for-like’ comparison. In order to ensure an appropriate comparison, the Commission should be required to consider the relativity between LLU

including collocation and backhaul to the interconnection point, with the UBS designation.

Regulation only where there is limited competition

- 97 The proposed service description for UBS includes a “competition test” which means that the Commission will only regulate UBS in markets where Telecom faces “limited or lessened competition”, or where the Commission has decided that regulation is nevertheless required. This is the standard approach in the Act.
- 98 We submit that a competition test should be included in the LLU service description also. As with the other regulated services, regulation should only be available where the market is not already competitive.

Requirement to review regulation

- 99 The amendments to the Act are a large increase in regulation. The stock take papers make it clear that it is intended to limit regulation over time as competition from alternative networks spread or competitors take up deeper forms of regulated access such as LLU.
- 100 We agree with this, and it is entirely consistent with overseas regulation. We suggest that the Bill should include measures to ensure regulation which is no longer required is removed. There are two situations where this is needed.
- 101 First, some of the new forms of regulation will not have expiry dates. A “standard terms” determination will not have an expiry date. We submit the Commission should be required to regularly review market conditions to check a standard term determination is still appropriate.
- 102 Second, the Commission should be required to regularly review market conditions to check whether the “shallower” forms of designated access services should remain in the Act. If there is workable competition based on UBS and naked DSL services, for example, then there is no need to continue to regulate for resale.
- 103 Telecom makes a number of detailed comments on the LLU and UBS service descriptions in **Appendix D**.

D THE COMMISSION'S PROCESSES

104 The Government's stocktake resulted in a number of proposals to change the way the Commission administers the Telecommunications Act.

Ensuring the new processes are timely

105 Some of the changes are fundamental. The key change is one of approach. The Bill implements a shift away from relying on industry based negotiations and initiatives in the first instance (for example through the Telecommunications Carriers Forum (*TCF*), and an emphasis on commercial negotiations where possible), to a position where a regulated solution from the Commission may be both a first and last port of call.

106 Telecom is committed to working with these new processes. However, the Bill does swing the pendulum right to the other extreme, where every issue is adjudicated on by the regulator before the wholesale customer can start selling its services. We suggest the more iterative approach used in the UK will facilitate faster outcomes. This is explained below.

107 The Bill proposes the following processes:

<p>Standard terms determinations (reference offers)</p>	<p>The Commission regulates a complete commercial contract containing all price and non price terms.</p> <p>Access seekers then choose to "contract in" on that basis.</p> <p>Any "contracting out" can occur but only after a standard terms determination has been made.</p> <p>The Commission can initiate a review of the standard terms and add, vary or delete any terms at any time. The thresholds, frequency etc for a review are not specified.</p>
<p>Residual terms determinations</p>	<p>A determination applying only to the relevant access seeker and access provider, amending a standard terms determination.</p>
<p>Section 27 determinations</p>	<p>As today an application can be made to have matters resolved. Key changes are that an application can be made notwithstanding the existence of a commercial agreement, and this process cannot be used if there is already a standard terms determination or process underway.</p>
<p>Commercial agreements</p>	<p>Outside the regulatory regime as agreed between operators.</p>

108 We think the standard terms/ reference offer process has the potential to be useful for wholesale customers, but as it is currently structured it will be unwieldy and slow. This is because:

- The Commission is required to adjudicate all terms in the “contract”, not just those which parties refer to the Commission. To date, the Commission has largely ruled on price. All other terms have either been agreed between the parties, or occasionally the Commission has provided a view on a non-price term. This is the starting point – even with this limited role there are concerns about delay. The new standard terms process will require the Commission to produce a full draft contract; and
- The Commission does not currently have the resources and skill to complete a standard term determination that mirrors a full contractual arrangement.

109 “Standard term” determinations (or “reference offers”) are a regulatory tool aimed at speeding up the entry of competing wholesale services into the market, avoiding disputes, providing transparency and providing confidence that the contractual terms have either been guided by the regulator or had some oversight or review from the regulator.

110 In our view, the process proposed in the Bill is unlikely to establish standard terms quickly. A comparison with the UK process highlights this. In the UK the regulator provides guidance as to what should go into a reference offer, but the detail is then drafted up by BT’s contractual and regulatory experts in line with that guidance. This enables a reference offer to be put in place more quickly. There is no consultation. If there are any disputes around particular clauses then a dispute can be referred to the regulator at any time and/or the regulator can consider amendments. In contrast, the Bill proposes a detailed determination process up front of all price and non price terms. Taking into account past experience and the Commission’s workload, this could take many months to more than a year.

111 We suggest a more flexible and faster process could look like:

- Commission carries out an assessment as to whether the applicable conditions are met (clause 30C(1)) of the Bill;
- At the same time, the Commission works towards issuing high level guidance (after short consultation) on what should be included in the standard term proposal;
- The access provider would produce standard terms in line with that guidance. The Commission would approve those terms as being in line with the guidance, would not be required to consult at that point, and would not be prevented from making changes at a later date if considered appropriate;

- The standard terms would be published by the access provider and access seekers could contract on that basis;
- Operators could then seek section 27 determinations on any changes to the standard terms. The key point here is that the wholesale customer can get in the market with a standard term offer pending refinement in a section 27 determination;
- The Commission would have the power to:
 - pass through to a standard terms determination parts or all of a section 27 determination; and
 - approve (with or without consultation) other amendments to standard terms that might be required from time to time to ensure that the contracts remain workable.

112 We recognise this approach would require a number of drafting changes to the Bill, both to the way the current processes run and the way they interrelate (e.g. the section 27 process is not currently available if a standard terms offer is in place, but under our proposal it would be). However, we do think changes like these will lead to wholesale customers getting services to market more quickly and the processes will be less costly.

Changes to standard terms

113 The Bill currently proposes two processes for amending a standard terms determination (bearing in mind a standard terms determination has no end date). They are:

- The Commission can make amendments on its own initiative to the standard terms determination; or
- An access seeker can apply for a residual terms determination to vary a term on a bilateral basis.

114 These processes introduce necessary flexibility. For example, if there is to be an operational improvement, this should flow through to regulated arrangements quickly.

115 We are concerned that we have no ability to initiate either process even if a change may be in the interests of the industry or needed to address an unavoidable operational issue. We submit the Bill should be amended to allow Telecom to initiate these processes.

Long term quality checks – the need for merits review

- 116 A significantly enhanced role for the Commission should also mean enhanced checks on the quality of the Commission's decision-making. In an environment where all industry participants are expected to invest in some level of infrastructure, there will need to be an enhanced commitment to quality decision-making.
- 117 With the best intentions in the world it should be acknowledged that with increased regulatory intervention comes an increased risk of regulatory error. In an industry as dynamic as telecommunications, quality regulation is critical. In our view therefore it is imperative that incentives are in place to ensure regulatory errors are minimised, and there are enhanced checks on the quality of decision making.
- 118 Merits based review in telecommunications is mandated in Europe (and some regulatory decisions have been overturned recently). There is also wide support for merits based review of regulatory decision-making in Australia, and it is now readily available and utilised under both the Australian *Gas Access Code*, the authorisation sections of the Trade Practices Act 1974, and in response to specified telecommunications decisions of the ACCC.
- 119 Professor David Round, himself a former regulator (including as a member of the Australian Competition Tribunal), has recently summarised the benefits of a merits based review process as follows:⁴

The merits review process:

- promotes transparency, accountability, and consistency in regulators' decisions;
- diminishes the likelihood of regulatory error and its consequential private and social costs;
- clarifies the operation of statutes and indicates where amendments may be necessary;
- promotes an environment in which long term investment decisions can be made with confidence; ensures that regulatory outcomes are consistent with policy intentions.

- 120 As a former regulator, Professor Round concludes that the availability of merits based review is an essential element of any socially efficient regulatory process "and an essential component of any regulatory best practice package."

⁴ Professor D Round, "The merits of merits reviews" [2006] NZLJ 237, at 240.

- 121 With the increasing push towards harmonisation of New Zealand and Australian business laws and regulatory environments, proper consideration of the adoption of merits based review in New Zealand is becoming increasingly necessary. Allowing for appeal on the merits would also bring New Zealand in line with other international practice. The EU has mandated appeals on the merits in all twenty-five EU member states. A number of appeals have occurred and a number of regulated decisions have been overturned as a result, illustrating clearly that the regulator does not always get it right.
- 122 In addition to the benefits listed above, merits review has the potential to legitimise regulatory frameworks and assumptions and the use of certain types of data, and to help establish precedent, all of which enhances certainty in the regulatory regime and increases the integrity of, and confidence in, the regulator. It also makes the regulator fully accountable for its actions. Poor decisions by the regulator can substantially damage the confidence of industry participants, and the market and investment in New Zealand.
- 123 We appreciate there are concerns about introducing merits based review in New Zealand – in particular delay and insufficient judicial expertise, but we believe these concerns can be readily addressed by the right process design.
- 124 Problems of delay, for example, could be overcome by a requirement that regulatory decisions must be implemented pending a final court decision except in exceptional circumstances, with a fast track appeal process. This is the approach in Europe.
- 125 Turning to expertise, Courts already have access to a lay Member and this would provide access to economic experts when dealing with appeals on the merits from regulatory decisions. Or a specialist tribunal could be established (overcoming both delay and expertise issues). It is important to note that while the Commission itself might be considered to be a specialist tribunal it cannot act as a check on itself and the incentives cannot be put in place for good regulatory decisions in the absence of knowledge of review by an independent court or body.
- 126 Whatever the design, in our submission the need for proper regulatory accountability in an industry where the regulator is being given significantly increased discretionary power requires that the Bill allow for a merits based review process.

ANNEX: GLOSSARY

**APPENDIX A - COMPARISON OF TELECOM'S PROPOSALS WITH BT
UNDERTAKINGS**

APPENDIX B – QUESTIONS AND ANSWERS

**APPENDIX C – TELECOM’S PROPOSALS FOR THE ACCOUNTING
SEPARATION REGIME**

**APPENDIX D – TELECOM’S COMMENTS ON SPECIFIC CLAUSES IN
THE BILL**