



COMMERCE COMMISSION

**Companion Paper on the Accounting Separation of  
Telecom Corporation of New Zealand Limited**

**Public Version  
(no confidential version)**

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## EXECUTIVE SUMMARY

- i. Part 2B of the Telecommunications Act 2001 (“**Act**”) mandates that the Commerce Commission (“**Commission**”) require Telecom to disclose information so that a wide range of people are informed about the operation and behaviour of Telecom’s network, wholesale, and retail business activities and services.
- ii. This paper is a companion document (“**Companion Paper**”) to the Telecom Accounting Separation Information Disclosure Requirements for Financial Years ending 2009 and 2010 (“**Requirements**”) for the accounting separation of Telecom issued under section 69ZB of the Act, and implemented pursuant to Part 2B of the Act. The purpose of this paper is to explain the reasoning behind the decisions contained in the Requirements document. The Requirements set out the Commission’s decision on the accounting separation disclosure requirements for the financial years ending 2009 and 2010.

### Consultation process to date

- iii. The Commission issued the Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom (“**Draft Principles Paper**”) in June 2008, which set out the high level principles for accounting separation. In October 2008, the Commission issued its Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act (“**Draft Notification**”), which detailed the proposed Requirements. A full record of the consultation documents and the submissions is available on the Commission’s website.<sup>1</sup>

### Statutory Framework

- iv. The overall purpose of Part 2B is to promote competition in telecommunication markets for the long term benefit of the end-users of telecommunication services within New Zealand. This purpose is achieved through public disclosure of reliable and timely information on the operation and behaviour of Telecom’s prescribed business activities and services.
- v. Section 69ZB grants the Commission discretion to specify the form and the manner in which the information is to be disclosed and the methodologies used to prepare it. The Commission is then required to publish summaries and analyses of the information received to promote wider understanding of Telecom’s operation and behaviour.

### Economic Principles

- vi. Competitive markets should support allocative, productive, and dynamically efficiency outcomes. The requirements disclosed through Part 2B should therefore provide transparency to Telecom’s operation and behaviour by allowing interested parties to assess whether competitive market outcomes are being promoted, and to monitor and detect potential behaviour that restricts competition.

### Reporting Requirements

- vii. The Requirements have been prepared to give effect to the purpose, to ensure a reasonable level of disclosure, and to be consistent with Telecom’s separation undertakings. They require the disclosure of financial information on the prescribed business activities and services at an aggregate level and, with regard to particularly

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<sup>1</sup> <http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx>

important regulated services, at a service level to facilitate “first order” tests of competition. In addition, the Commission may require Telecom to supply to the Commission confidential compliance monitoring information by separate letter. The Commission has given preliminary notice of its intended compliance monitoring information requirements.

- viii. The Commission has reduced reporting requirements for Telecom’s 2008/2009 financial year to enable Telecom to develop robust methodologies, processes and systems.
- ix. The information to be publicly disclosed for the Telecom financial year ending 2009 consists of:
  - Regulatory statements of financial performance;
  - Regulatory statements of mean capital employed;
  - Regulatory statements of fixed assets;
  - Regulatory reconciliation reports;
  - Accounting policy, attribution, and asset valuation manuals; and
  - Audit opinions.
- x. The information to be publicly disclosed for the financial year ending 2010 consists of all the information published in 2009 (with some greater detail), with the addition of product statements. Cost information is to be prepared on the basis of both historical cost accounting and current cost.
- xi. The Commission expects to require compliance monitoring information consisting of:
  - Regulatory statements of asset movement;
  - Detailed regulatory statements of fixed assets; and
  - Stand-alone cost and long-run incremental cost data for services (for the financial year ending 2010 only).

# Part A - The Commission's Framework for Information Disclosure

## 1. INTRODUCTION

1. Part 2B of the Telecommunications Act mandates that the Commerce Commission require Telecom to disclose information so that a wide range of people are informed about the operation and behaviour of Telecom's network, wholesale, and retail business activities and services.
2. Telecom<sup>2</sup> is a vertically and horizontally integrated telecommunications service operator that provides internet, mobile, data, and voice services to retail and wholesale markets in New Zealand and in overseas markets. In 2008 Telecom reported revenues in excess of NZ\$5.5 billion and net earnings of over NZ\$700 million. Telecom is listed on the NZX, ASX and NYSE and has a market capitalisation of around NZ\$4.8 billion. With this market capitalisation, Telecom comprises approximately 10% of the total New Zealand stock market capitalisation of NZ\$46.6 billion<sup>3</sup>.

### Purpose

3. This paper is a companion document to the Telecom Accounting Separation Information Disclosure Requirements for Financial Years ending 2009 and 2010 ("**Requirements**") for the accounting separation of Telecom issued under section 69ZB of the Act, and implemented pursuant to Part 2B of the Act. The purpose of this paper is to explain the reasoning behind the decisions contained in the Requirements.
4. The Requirements set out the Commission's enforceable information disclosure requirements applicable to Telecom for the Telecom financial years ending June 2009 and June 2010. The Commission expects to review and amend the Requirements over time to reflect the changes in technology, services, and the information needs of the wide audience.

### Process Overview

5. On 20 June 2008, the Commission issued a consultation document, the Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom, on the principles and regulatory reporting requirements for the accounting separation of Telecom ("**Draft Principles Paper**"). In response to this paper, the Commission received a total of five submissions. Submissions were received from Telecom, InternetNZ, NZ Communications, the Ministry of Economic Development ("**MED**"), and ISPANZ.
6. Following the submissions, the Commission sought cross-submissions, and received three. Cross-submissions were received from Telecom, InternetNZ, and NZ Communications.
7. On 23 October 2008, the Commission issued the Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act ("**Draft Notification**"). In response to this paper, the Commission received two submissions: one from InternetNZ, and one from Telecom.

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<sup>2</sup> Telecom as defined by section 5 of the Telecommunications Act 2001.

<sup>3</sup> Source: <http://www.nzx.com/markets/nzxs> (February 2009).

8. Telecom also commissioned PricewaterhouseCoopers LLP UK (“**PwC**”) to prepare a report on the potential costs of implementing the requirements described in the Draft Notification.
9. On 6 March 2009, the Commission issued a draft copy of the Requirements Paper and called for submissions on the clarity of the requirements paper in defining Telecom’s obligations for information disclosure. A copy of this companion paper was also made available to assist the review of the requirements. In response the Commission received submissions from Telecom, InternetNZ, Callplus, Kordia, Covec and Woosh.
10. In addition, Telecom have presented to the Commission information regarding the capabilities of Telecom’s current accounting practices and systems.
11. A full record of the consultation documents and the submissions received by the Commission is available on the Commission’s website<sup>4</sup>.
12. The submissions received by the Commission during this consultation process have been appropriately considered in preparing the accompanying Requirements document. The submissions and the Commission’s decisions are covered in detail in Part B of this paper.

### **International experience**

13. Regulators in a number of overseas jurisdictions have introduced financial transparency over the operation and behaviour of telecommunications incumbents to counter the potential for anti-competitive behaviour, which might be undertaken by an incumbent to deter market entry, or to impose constraints on competitors in downstream markets.
14. For example, in the United Kingdom, British Telecom (“**BT**”) is subject to both operational undertakings and accounting separation obligations. The Office for Communications (“**Ofcom**”), the independent regulator and competition authority for the UK communications industries, requires BT to maintain and submit detailed regulatory accounting documents.<sup>5</sup> Ofcom also has the ability to directly interrogate BT’s regulatory accounting data using a data extraction tool.<sup>6</sup> In Ofcom’s view, both the operational separation undertakings and the requirements for Information Disclosure are necessary to address competitive concerns in the UK telecommunications market.
15. In Belgium, the Royal Decree specifies accounting principles for companies with significant power in the telecommunications market. Companies with significant market power are required to state expenses (including capital costs) and revenue, for the *Core Network, Local Access Network, Retail, and Other* activities. The Belgium Institute for Postal services and Telecommunications (BIPT), the Belgian regulatory authority, requires the incumbent Belgacom to prepare separated accounts for all the activities for which Belgacom has been declared to have significant market power.
16. The Australian regime specifies the cost allocation methodology to be used for information disclosure in its Regulatory Accounting Framework. The carriers themselves are responsible for maintaining the Regulatory Accounting Procedures

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<sup>4</sup> <http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx>.

<sup>5</sup> These documents include detailed financial statements, valuation and attribution documents (with the latter setting out more detailed description of policies, methodologies, systems, processes and procedures for calculating the revenue, costs, assets and liabilities).

<sup>6</sup> See, for example, Ofcom, *Simplification Plan — Reducing Regulation and Minimising Administrative Burdens*, 11 December 2008, available at: <http://www.ofcom.org.uk/about/accoun/simpl08/simpl08.pdf>

Manual. This manual includes studies, surveys and models that are used for allocation purposes and worked examples of all allocation methods.

17. The European Regulators Group (ERG),<sup>7</sup> an independent body formed by the E.C. and composed of the regulators of EU member states, regularly publishes guidelines for Regulatory Accounting and reports on best practice. These guidelines have been adopted by a number of European regulators to promote competition in their respective telecommunications markets.

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<sup>7</sup> See <http://www.erg.eu.int>.

## 2. STATUTORY FRAMEWORK

### Purpose and Disclosure

18. Section 69ZB(1) of the Telecommunications Act 2001 obliges the Commission to require Telecom to undertake accounting separation:<sup>8</sup>

The Commission must require Telecom to prepare and disclose information about the operation and behaviour of all or any of its network, wholesale, or retail business activities as if those activities were operated as independent or unrelated companies.

19. In defining and implementing the information disclosure requirements, the Commission considered the purpose of the information disclosure regime as set out in section 69Y of the Act:

#### **69Y Purpose**

The purpose of this Part is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services in New Zealand by requiring that reliable and timely information prescribed by the Commission is made publicly available—

(a) by Telecom, so that a wide range of people are informed about the operation and behaviour of Telecom's network, wholesale, and retail business activities and services; and

(b) by access providers, including Telecom, so that a wide range of people are informed about the operation and behaviour of prescribed businesses that provide prescribed services, in order to monitor and facilitate compliance with prescribed applicable access principles.

20. The purpose of Part 2B shares a fundamental element with that of Part 2 and Part 2A – that is, to “promote competition in telecommunication markets for the long-term benefit of end users of telecommunications services within New Zealand.”<sup>9</sup> In Part 2B, however, this purpose is to be achieved by ensuring that Telecom publicly discloses timely and reliable information concerning its operations and behaviour.
21. Section 69Z requires that Telecom’s information disclosure obligations be reasonable, having regard to the purpose in section 69Y, the confidentiality of the information in question, and the time required to prepare the information.
22. In making these requirements, the Commission has considered both the purpose and reasonableness of the information disclosure requirements and has, in particular, sought to utilise as much as possible the systems and information which Telecom currently maintains for existing financial purposes.
23. Pursuant to section 69ZB(4) the Commission may require Telecom to disclose:
- financial statements;
  - asset valuations;
  - prices, terms and conditions;
  - costs and cost allocation methodologies;
  - contracts;
  - related party transactions;
  - financial and non-financial performance measures;
  - plans and forecasts;
  - transfer payments;

<sup>8</sup> Section 69ZB(1), emphasis added.

<sup>9</sup> See sections 18(1) and 69A(a) of the Act.

- network capacity information; and
  - policies and methodologies.
24. The Commission may also define the business activities and services for which information must be disclosed, require the adoption of particular methodologies, and prescribe the information to be included in financial statements.<sup>10</sup>
  25. The information disclosure requirements may also include information concerning specific activities and services within the network, wholesale, and retail categories pursuant to section 69ZB(2). This extends information disclosure to any activity or service within the network, wholesale or retail categories - including regulated services (and Relevant Services defined in the operational separation Undertakings) and other (non-regulated) services.
  26. In addition to the considerations set out above, the Commission has also had regard to Telecom's separation plan (including the separation undertakings) to ensure consistency with the requirements made under section 69ZB.<sup>11</sup>
  27. As required by section 69ZG the Commission will publish summaries and analyses of all information received<sup>12</sup> as soon as practicable after it is supplied.
  28. In making these requirements, the Commission consulted persons with a material interest and considered their responses to the Commission's consultation documents, the Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom<sup>13</sup> and the subsequent Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act.<sup>14</sup> The Commission has given careful consideration to all submissions received. Material issues raised in submissions received during the consultation process are addressed along with the Commission's reasoning in this Companion Paper.<sup>15</sup>

## Compliance

29. Telecom is obliged to prepare and disclose the information required by the Commission under section 69ZB<sup>16</sup> and must provide the Commission with copies<sup>17</sup> and any further information requested by the Commission to monitor compliance with the requirements.<sup>18</sup> The Commission may also require the information to be audited and/or verified by statutory declaration.<sup>19</sup>

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<sup>10</sup> Section 69ZB(5).

<sup>11</sup> Under section 69ZB(3) the requirements must be finalised only after a separation plan has been approved under Part 2A, and must be consistent with that separation plan. Telecom's Separation Plan (comprising the undertakings) was approved by the Minister of Communications on 30 March 2008 and became legally enforceable from 31 March 2008.

<sup>12</sup> *Ibid*, section 69ZG.

<sup>13</sup> Commerce Commission, 20 June 2008, see:

[www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx](http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx)

<sup>14</sup> Commerce Commission, 23 October 2008, see:

[www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx](http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/AccSepofTelecom/documents.aspx)

<sup>15</sup> Where a view has been expressed by a submitting party, and has later been retracted or modified in a later submission, then the Commission considers the most recent view of the interested party as the party's view on the matter.

<sup>16</sup> Section 69ZB(7).

<sup>17</sup> Copies must be provided within 5 working days after information is first disclosed (section 69ZF(1)(a)).

<sup>18</sup> Any such request must be in writing (section 69ZF(1)(b)).

<sup>19</sup> See sections 69ZD(1)(d), (e) and 69ZF(3) of the Act.

30. The Commission may provide exemptions to the Requirements pursuant to section 69ZD(1)(h). The Commission may also make requirements from time-to-time pursuant to section 69ZD(1)(k).
31. If Telecom fails, without reasonable excuse, to comply with these requirements the Commission may serve a civil infringement notice<sup>20</sup> or apply to the High Court for a pecuniary penalty.<sup>21</sup> The Act provides for pecuniary penalties of up to \$1 million for each breach of the information disclosure requirements.<sup>22</sup>

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<sup>20</sup> *Ibid*, sections 156D – 156K. See also the Telecommunications (Civil Infringement Notice) Regulations 2007.

<sup>21</sup> *Ibid*, sections 156A, 156B.

<sup>22</sup> See section 156L(3)(b) of the Act.

### 3. ECONOMIC PRINCIPLES

#### Introduction

32. In order to promote competition under Part 2B of the Act, the Commission must require Telecom to disclose information so that “*a wide range of people is informed about the operation and behaviour of Telecom’s network, wholesale, and retail business activities and services.*”<sup>23</sup>
33. It is therefore important that the information disclosed allow interested parties, including the Commission, to assess whether competitive market outcomes are being promoted, and to monitor and detect potential behaviour that restricts competition. Such information can then be used by interested parties to pursue competitive market outcomes, and thereby promote competition in the telecommunications markets.
34. The Commission usually gives regard to the following three aspects of efficiency when evaluating the competitiveness of markets:
- ***Allocative efficiency***, which involves ensuring that resources are allocated to those producers and consumers who value them most highly. In an allocatively efficient market, the goods and services that are produced in the economy are the ones most valued by consumers, and the distribution of production costs amongst firms within the industry minimises industry-wide costs. Allocatively efficient outcomes are achieved when prices for services equal their long-run marginal costs of supply.<sup>24</sup> This is sometimes referred to as having ‘cost-based’ ‘or cost oriented’ prices.
  - ***Productive efficiency*** involves each firm combining its inputs or resources in such a way as to produce a given level of output of goods and services at a minimum cost to society.
  - ***Dynamic efficiency*** is associated with ensuring that incentives are maintained for an infrastructure provider to undertake ongoing investment in essential infrastructure over time. Dynamic efficiency has sometimes been defined as ensuring that the service provider has incentives to undertake the appropriate level of investment at a time where the net present value to society from the investment is maximised.

#### Assessing the Status of Competition

35. Competitive behaviour is likely to create allocative, productive, and dynamic efficiencies. Information disclosure can play an important role in promoting competitive, and therefore efficient, outcomes in the telecommunications market.
36. Behaviours such as price discrimination<sup>25</sup> and cross-subsidisation can potentially generate distortions in the market place and lessen competition. The result of decreasing

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<sup>23</sup> Section 69Y of the Act.

<sup>24</sup> The Commission recognises that in markets such as telecommunications, which are characterised by some natural monopolistic cost structures, the achievement of cost recovery may not necessarily be possible when pricing at the long-run marginal (or incremental) cost. As allocative efficiency is only desirable insofar as the recovery of efficiently incurred costs is possible under the constraints imposed by the natural monopoly outcome, a price based on some average cost measure is often provided for in practice.

<sup>25</sup> The Commission acknowledges that in some circumstance price discrimination can lead to benefits to end-users.

competition in markets is allocative, productive, and dynamic inefficiencies, and welfare losses to society.

37. Examples of behaviour which could have a negative impact on competition may be:
- **Price discrimination:** This can occur in the wholesale market if a vertically integrated company, such as Telecom, charges a higher (usually above-cost) price to its downstream competitors than it implicitly charges its own retail affiliates. Discrimination between internal and external customers increases access seeker's downstream costs, resulting in a margin squeeze.
  - **Cross-subsidisation:** A firm with substantial market power can leverage off its market power in one market in order to subsidise its operations in a competitive market. For example, it can charge a price above cost in the product market in which it has market power, and a price below cost in the competitive market. Where there is a vertically integrated provider that has substantial market power in the wholesale market, it can charge an above-cost price in the wholesale market, while charging below efficient cost-based price in the retail market. This will impose a vertical-price squeeze on the wholesale access seeker attempting to compete with the vertically integrated provider.
  - **Below-cost pricing:** A firm with substantial market power could choose to sell a product below the costs of production for a sustained period of time, with the intention of deterring entry or driving a rival out of business. While the firm behaving in this manner may sustain losses in the short-run, by deterring entry and eliminating competition, it will expect that such losses will be more than offset by its ability to increase market share and profitability in the long run.
38. Information disclosure, by ensuring that a vertically integrated company such as Telecom makes its prices, revenues, costs, and internal transfer prices transparent, can be a powerful tool in the early detection of the types of behaviours described above that may impact competitive outcomes. Therefore, information disclosure can allow a wide range of end-users to assess the behaviour of Telecom, and may act to deter the integrated provider from engaging in behaviour that could lessen competition in the future.
39. In addition, information disclosure can help to identify whether there is competitive pressure arising in the telecommunications market. For example, if there is competitive pressure the firm subject to the information disclosure requirements might respond by investing in new technologies that decrease operating expenses and increase performance and capacity for the long-term benefit of the end-users.
40. The Act authorises the Commission to require Telecom to prepare and disclose financial and non-financial information. In particular, it allows the Commission to require costs and revenues to be allocated across the business activities defined in the Act. It is therefore most closely aligned to the concept of allocative efficiency.
41. By providing a wide range of people with visibility to Telecom's returns on its regulated services, it allows for a public assessment of dynamic efficiency.

### **Practical Considerations**

42. There are a number of considerations that have to be taken into account when assessing competition using the efficiency concepts described above.

43. Information disclosure by Telecom under the accounting separation requirements of Part 2B can be used to ensure that allocative efficiency is achieved. This is done by disclosing information that makes it possible for interested parties to monitor the relationship of price to the long run costs of supplying the service, and the potential for any behaviour that restricts competition.
44. In telecommunications networks, many of the inputs necessary to supply a range of services are shared. In order to make an assessment of the potential effects on competition, and therefore on allocative, productive and dynamic efficiencies, all of the input costs have to be allocated across all services, whether regulated or otherwise.
45. Transparency of input cost allocation across different service groups or services helps to ensure that (i) overall costs are not over- or under-stated, i.e. a full allocation of total costs is taking place; and (ii) costs have not been over- or under-allocated to regulated wholesale access services.
46. Further, as the historical cost-based accounts of the firm represent its cost structures and not necessarily that of an efficient operator, they may not provide an adequate basis for identifying issues related to competition. Unlike other utilities (such as gas and electricity distribution), telecommunications operators can face rapid technological change, may supply a range of different services, and are more likely to be subject to entry by competitors. In telecommunications, this has led regulators to adopt current cost methodologies involving the use of replacement costs and optimisation techniques to derive ongoing estimates of the forward-looking costs of the inputs needed to provide services. The Requirements use such techniques where appropriate to support an assessment of competition and productive efficiency.
47. Dynamic efficiency relates to ensuring ongoing investment and the supply of services over the long-term. This is achieved by allowing the operator to expect to earn a normal rate of return on its efficiently invested capital necessary to supply regulated services (that is, the firm should have the expectation of earning a normal economic profit, or a net present value of zero (i.e. an  $NPV = 0$ ) when supplying regulated services.). The Requirements will enable the Commission and other users of the information to assess whether long-term benefits to end users are being promoted.

#### 4. REPORTING REQUIREMENTS

48. In order to evaluate the operations and behaviour of a vertically integrated firm, a range of tests and reporting requirements can be used. The following table provides a generic overview of how these tools may be used and how they will promote competition for the long-term benefit of end-users in New Zealand.

Objective	Efficiency concept	Potential information to be used	Potential disclosure requirements	Potential tests
Promote competition for the long-term benefit of end-users	Allocative efficiency	Attribution methodology & cost information Price information Return measures	Attribution methodologies Product statements Asset statements Statement of Financial Performance	Non-discrimination Cross-subsidisation Price squeeze Benchmarking Efficiency testing
	Productive efficiency	Cost information Attribution methodology Volumes Charges internal and external	Product Statements	
	Dynamic efficiency	Capital expenditure Asset (replacement) values Valuation methodology	Valuation methodologies Statement of Assets Asset movements/ Ongoing investments	

49. The Commission has balanced the needs of various parties by introducing reduced reporting requirements on Telecom during the first financial year. This will provide Telecom time to develop robust methodologies, processes, and systems.
50. The reporting requirements in the first year will provide information on Telecom's service groups (as defined by the Commission) at an aggregate level, as well as information on the accounting policies and the methodologies that will be used for asset valuation and attribution.
51. The Requirements reduce information asymmetry by providing transparency of the information which Telecom shall disclose to a wide audience.
52. Further, the Requirements enable the assessment of the cost-orientation of regulated services. The disclosed information will promote competition and enhance efficiency in the telecommunications sector by making transparent any pricing anomalies and inefficiencies.
53. The Requirements also provide a filtering mechanism for identification of issues relating to vertical and horizontal price squeezes and cross-subsidies, which can lead to high and non-transitory entry barriers as well as excessive prices for end-users.

54. Further, it is envisaged that the transparency afforded by the Requirements will encourage efficient investment decision-making by market participants, including Telecom, thereby promoting innovation and enhancing dynamic efficiency.

## Part B - The Commission's Reasoning and Decisions

### 5. COMMON ISSUES

55. During the consultation process, a number of overarching issues were raised in relation to the Requirements. As these issues relate to the overall application of the accounting separation requirements they are dealt with in the following section.

#### Operational Separation

56. A number of parties submitted on the relationship between accounting separation and operational separation. Section 69ZB(3) of the Act requires:

Any requirements under this section must be finalised only after a separation plan has been approved under Part 2A, *and must be consistent with that separation plan.*

#### Submissions

57. Telecom argued that because accounting separation is being implemented after operational separation,<sup>26</sup> the accounting separation requirements should be “more targeted.”<sup>27</sup> In Telecom’s view, the purpose of accounting separation is already largely met by the separation plan.<sup>28</sup>

58. In its submission on the Draft Notification, Telecom stated:<sup>29</sup>

Accounting separation, while *additional* to operational separation, will not be reasonable if it is set *in isolation* of what operational separation is already achieving. ... The existence therefore of operational separation in New Zealand before accounting separation *must* influence the design of the accounting separation requirements.

59. Telecom argued that the operational separation requirements “comprehensively address”<sup>30</sup> such objectives as discrimination, EOI, and cross-subsidisation,<sup>31</sup> and therefore the accounting separation requirements should be minimal.

60. Telecom argued that the Commission’s approach to accounting separation should be developed in a complementary manner to the operational separation Undertakings,<sup>32</sup> to avoid duplication of effort.<sup>33</sup>

61. InternetNZ disagreed with the Telecom’s view that operational separation required narrowly focused accounting separation requirements, noting that:

Ofcom has addressed whether there should be changes to BT’s regulatory financial reporting obligations, post-introduction of operational separation, on several occasions between 2006 and 2008. Rather than reducing the disclosure obligations, Ofcom has generally confirmed them and, in some instances, added additional reporting obligations.

<sup>26</sup> See Part 2A of the Act for the operational separation requirements.

<sup>27</sup> Telecom, *Submission in respect of the Commerce Commission’s Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom*, 18 July 2008 (“Telecom Draft Principles Submission”), paras 23-24.

<sup>28</sup> Telecom Draft Principles Submission, paras 25 *et seq.*

<sup>29</sup> Telecom, *Submission in respect of the Commerce Commission’s Draft Notification of Information Disclosure Requirements on telecom New Zealand under part 2B of the Telecommunications Act*, 7 November 2008 (“Telecom Draft Notification Submission”), para. 6.

<sup>30</sup> Telecom Draft Notification Submission, para. 41.

<sup>31</sup> *Ibid.*

<sup>32</sup> The Telecom Separation Undertakings approved by the Minister of Communications on 30 March 2008 in accordance with section 69K(2)(c) of the Telecommunications Act 2001 (“**Undertakings**”).

<sup>33</sup> See Telecom Draft Notification Submission, paras 6, 7, 40-46.

62. InternetNZ also disagreed with Telecom regarding the relationship between operational separation under Part 2A and accounting separation under Part 2B. InternetNZ submitted that accounting separation is an essential adjunct to operational separation and other aspects of the telecommunications sector.<sup>34</sup> InternetNZ, in response to Telecom's submission arguing for a reduction in accounting separation requirements due to operational separation, noted that in the UK few changes were made to the regulatory accounting framework following the introduction of operational separation. InternetNZ specifically noted the need for having accounting principles relating to the level of granularity of cost allocations and transfer charges to avoid the use of overly favourable accounting policies.<sup>35</sup>

*Commission View*

63. The Commission has considered operational separation in defining the Requirements in order to ensure the information disclosure requirements are reasonable and consistent.
64. While Section 69ZB information disclosure must be consistent with operational separation, it remains different from, and in addition to, the operational separation requirement and the applicable statutory financial reporting requirements mandated by operational separation under Part 2A. Parliament specifically enacted separate purpose statements in the Telecommunications Amendment Act 2006 for operational separation under Part 2A and information disclosure under Part 2B. As the Ministry of Economic Development noted in its Consultation on the operational separation requirements:
- The accounting separation framework and information disclosure provisions outlined in Part 2B of the Act will further increase the transparency around the operations and behaviour of the separated units.
65. Accounting separation promotes competition by requiring the public disclosure of financial information. In order to be reliable and meaningful when assessing price discrimination and cost-orientation, the financial information must be sufficiently complete and coherently organised. The accounting separation requirements developed by the Commission provide this level of coherence, which is not present at the same level in the operational separation context. The accounting separation information disclosure requirements better capture the complex interrelationship of costs, revenues, and resource allocation.
66. Some financial information may be required to be disclosed to the IOG and the Commission under the operational separation Undertakings, but not the general public. However, the purpose of Part 2B is to inform a wide range of people. As such, some financial information that may be disclosed under the Undertakings may also be disclosed under Part 2B to achieve that particular purpose. If the information is already prepared under Part 2A, disclosure is a simple matter of posting the information, and therefore will not impose any additional burden on Telecom.
67. The Commission has sought to ensure that the Requirements are consistent with the Undertakings in order to minimise the work required to fulfil the reporting requirements, and in order to ensure the accounting separation requirements are

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<sup>34</sup> InternetNZ, *Submission to the Commerce Commission on Draft Notification of Information Disclosure Requirements*, 7 November 2008, para 2.

<sup>35</sup> InternetNZ, *Further Submission to the Commerce Commission on Draft Principles and Regulatory Reporting Requirements*, 15 August 2008, pages 6-7.

reasonable within an operational separation environment. In particular, the Commission has considered:

- the definition of business units contained in the Undertakings when defining the network, wholesale, and business activities and services in Part 2B; and
- the reasonableness of the information disclosure requirements in light of the requirements imposed upon Telecom by the Undertakings, particularly the equivalency of inputs and arm's-length rules.

### **Disaggregation into Services Groups**

68. The Act requires that:<sup>36</sup>

The Commission must require Telecom to prepare and disclose information about the operation and behaviour of all or any of its network, wholesale, or retail business activities as if those activities were operated as independent or unrelated companies.

69. In addition, the Act authorises the Commission to require reports on specific business activities and/or services within those categories:<sup>37</sup>

The Commission may require Telecom to prepare and disclose separate information about all or part of separate prescribed business activities or separate prescribed services, within the network, wholesale, or retail categories.

70. In addition, the Commission may:<sup>38</sup>

...define the prescribed business activities and prescribed services in respect of which Telecom must prepare and disclose information... .

### *Submissions*

71. Telecom's submission on the Draft Principles Paper proposed that the prescribed business activities and services should be based on Telecom's current management structure, and therefore should consist of:<sup>39</sup>

- Chorus;
- Telecom Wholesale;
- Retail (excluding Gen-i);
- Technology and Shared Services;
- Other businesses (overseas operations and Gen-i); and
- Corporate Centre.

72. The Commission's Draft Principles Paper did not require the inclusion of Gen-i, which is one of Telecom's retail units. Telecom's submission supported this position and argued that this was justified on the grounds that Gen-i has operations outside New Zealand (in Australia).<sup>40</sup>

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<sup>36</sup> Section 69ZB(1).

<sup>37</sup> Section 69ZB(2).

<sup>38</sup> Section 69ZB(5)(a).

<sup>39</sup> Telecom Draft Principles Submission, para. 33.

<sup>40</sup> *Ibid*, para. 36.

73. Telecom also submitted that Wholesale should not be disaggregated into relevant and non-relevant services.<sup>41</sup>
74. InternetNZ submitted that Gen-i should be included as they considered that it is required to provide transparency and a full picture of Telecom's retail activities.<sup>42</sup>

*Commission View*

75. The Commission's view is that the term "Services Groups" will be used to define the business activities and services for which information disclosure is required. Consistent with the categories described in the Act, there will be three primary Services Groups: the Network, Wholesale, and Retail Services Groups. However, some activities and services, such as corporate, finance and Australian activities, do not fall within those Services Groups and are allocated to an "other" category, namely the Other Services Group. This approach will ensure that all NZ costs and revenues are allocated to the relevant Services Group(s) in a fully transparent way.
76. This split is reflective of the commercial arrangements which would occur if Telecom's business activities were performed by independent or unrelated entities, consistent with section 69ZB(1).
77. Statutory or management accounts reflect the organisational structure of the business. While over the short term it would be convenient for Telecom to implement regulatory reporting using its current management structure, it would not further the purposes of Part 2B. Part 2B requires the disclosure of information regarding Telecom's network, wholesale, and retail business activities. However, Telecom's management structure incorporates many of these elements within separate companies or divisions. For example, Gen-i provides both retail and international services, and Technology and Shared Services provides inputs to all three business activities. However, in order for the disclosure requirements to provide information regarding Telecom's operations and behaviour within the network, wholesale, and retail activities and services, the service groups must be consistent with the three types of business activities defined by the Act.
78. In addition, reliance on such accounts has the inherent risk that should the company's management structure change, the way information is reported may also change. Such changes could impair the comparability of information between years and thus make it harder to identify changes in investment and operational behaviour. To ensure that data can be built into a time series that is comparable over time, regulatory accounts should be independent of the management structure.
79. From 2010 the Wholesale Services Group will have separate reporting of relevant services, as that term is defined in the Undertakings. This separate reporting is necessary because relevant wholesale services include network assets which are also used to deliver other non-regulated services.
80. The requirement for separate reporting is expected to impose only minimal additional costs on Telecom. Telecom is already obliged to prepare financial statements which provide information regarding regulated services. In order to prepare and publish this information, Telecom must split costs between relevant and non-relevant services.
81. The Commission acknowledges that there are various ways to allocate common costs to business activities, service or service groups. However, splitting these costs will not be

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<sup>41</sup> *Ibid*, para. 35.

<sup>42</sup> InternetNZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para. 6.1.

arbitrary, as suggested by Telecom's submission, but consistent with the allocation rules specified in the attribution manual applying the principle of causality.

82. As the product migration plans in the operational separation Undertakings are delivered on through to 2012, the mix of relevant and non-relevant services that make up the Wholesale Services Group will change. The availability of disaggregated information from the Wholesale Services Group will help the Commission and interested parties track the financial effects of technology changes on the allocation of costs. The split will make the changing flow of costs more transparent.
83. The Commission does not currently consider it necessary to require a similar breakdown within the Network Services Group.
84. The Commission's view is that Gen-i's New Zealand activities must be included in the Retail Services Group. It is an integral part of Telecom's retail business activities. To exclude them would reduce the value of the Section 69ZB information disclosure in meeting its purpose of providing information about Telecom's retail business activities.

#### *Commission Decision*

85. The Commission requires that Telecom prepares its information disclosure under section 69ZB at a disaggregated level.
86. As defined by clause 2.1 of the Requirements, for the financial years ending June 2009 and June 2010, Telecom is required to prepare the regulatory financial statements on the basis of their Network, Wholesale, and Retail business activities.

### **Accounting Standards**

87. Section 69ZB(5) authorises the Commission to prescribe the methodologies to be applied in the preparation of the information. In the Draft Papers, the Commission proposed prescribing asset valuation and attribution methodologies.

### **Accounting Basis**

88. In practice, there are a number of accounting standards used for the preparation of financial statements. Among others, they include:
  - Historical cost accounting (HCA); and
  - Current cost accounting (CCA) measures.
89. Historical cost accounting ("HCA") information is generally accepted as being adequate for management or statutory financial purposes by a number of existing accounting standards (such as GAAP, IFRS, etc.) and is understood by a wide range of people.
90. However, under certain circumstances, HCA may provide unsatisfactory indicators for regulatory decision making. For example:
  - HCA understates the values of assets through periods of high inflation;
  - HCA overstates the economic value of assets during periods of significant technological developments;
  - the historical records of purchase prices or acquisition costs may not be available. This is particularly the case for assets and infrastructure with a long lifetime;

- the impact of “wrong” investment decisions, over-payment of assets or over-investment are carried through for long periods; and
  - there is no incentive for ensuring asset performance is efficient in an economic sense.
91. HCA can be appropriate in industries with technological stability and less likelihood of competitive entry, as there will be no major change in the value of the asset base over time. However, as telecommunication operators generally provide a range of services where the inputs necessary to supply these services are often subject to a rapid technological change - and some services are subject to competition from new entrants - regulatory authorities often make use of alternative accounting techniques.
92. CCA concepts have been developed as an alternative to historical cost accounting in a world of changing prices due to inflation or other reasons such as rapid technological change.
93. Under certain conditions CCA will have the following advantages:
- it matches the economic value when inflation is high;
  - it gives an indication of capital cost to potential market entrants;
  - it allows for technological gains or improved design methods to be captured; and
  - it does not necessarily rely on historical acquisition records.
94. CCA concepts may also have some disadvantages which include:
- subjective parameters (e.g. current prices are sometimes difficult to obtain);
  - a lack of incentives to optimise the asset design;
  - a higher effort necessary to calculate the asset values including the regular re-calculation;
  - a dependence on exogenous factors such as a replacement or inflation index; and
  - a substantial revaluation gain on certain parts of the network, as older assets are based on the replacement costs, which can be substantially higher than the indexed depreciated historical cost of the asset.<sup>43</sup>
95. The use of CCA evaluation is intended to measure the financial performance of the regulated company in a way that is broadly consistent with the costs faced by new or potential competitors in a market wishing to offer services at a price that would allow them to recover their current costs. In this sense CCA-derived information assists with the promotion of competition.

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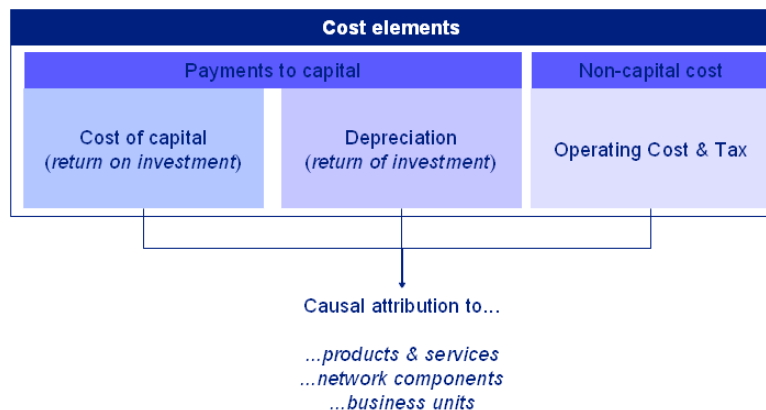
<sup>43</sup> The ERG, *ERG Common Position: Guidelines for implementing the Commission Recommendation C (2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications*, ERG (05) 29, page 11, highlights this difficulty associated with transitioning to CCA standards, stating that:

there may be significant transitional issues raised when CCA is implemented. For example, the valuation of the asset base may result in significant windfall holding gains and losses for the undertaking subject to accounting separation regulation. It may not be appropriate, depending on the specific regulatory objectives of the NRA {National Regulatory Authority}, to allow those windfall gains and losses to be reflected in pricing decisions.

96. For regulated services, the access price is often based on what is referred to as the “forward-looking long-run incremental cost” of supplying the service. This forward-looking cost-based price estimate, which is considered by many regulators to promote competition for the long-term benefits of end users, is a current cost standard that is derived predominantly using CCA information, but can also employ some HCA information.<sup>44</sup>

### **Asset Valuation**

97. The telecommunication business is relatively capital intensive, and therefore the cost of the physical assets needed to provide products and services is a significant portion of the cost of providing those products and services. The treatment of these assets can significantly impact the reported profits and financial position of the firm. This involves not only the identification and valuation of the assets, but also the annualisation of the capital investment costs, i.e. depreciation and the return on capital, and the attribution of these costs to defined services, products or product groups as shown in the illustration below.



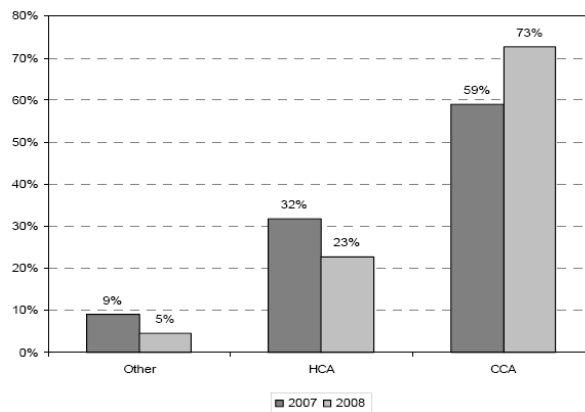
98. In order to define the asset base for services or products, the network elements necessary for providing the services have to be identified and valued. This needs to be done using a sufficient level of granularity.
99. In order to implement the information disclosure regime under Part 2B of the Act, the Commission may require Telecom to disclose asset valuations using specific methodologies that meet the purpose of the Act.
100. HCA is the conventional accounting method, wherein assets are valued at the cost recorded at the time of their purchase and depreciated accordingly. In contrast to HCA asset values and costs, CCA methodologies prescribe the valuation of assets at current or replacements cost, which are determined by finding current market prices for assets.
101. Where assets are likely to move in and out of the asset base due to such causes as technological progress, or there is a likelihood of competitive entry in markets that the asset base supplies, current cost methodologies are likely to yield a net asset cost base and measure of profit similar to that expected under competitive market conditions.

<sup>44</sup> See, e.g., H. Ergas, *TSLRIC, TELRIC and Other Forms of Forward-Looking Cost Models in Telecommunications: A Curmudgeon's Guide*, 1998, a paper prepared for the 1998 EU competition Workshop at the Robert Schuman Centre of European University Institute, available at: <http://conceptnews.com.au/artman2/uploads/1/papers-ergas-tslric-final-nov98.pdf>.

102. In order for the wide audience to assess whether Telecom is behaving efficiently, therefore, information regarding the assets should be publicly disclosed .

### *International Practice*

103. In September 2003 the Independent Regulators Group (“**IRG**”)<sup>45</sup> Regulatory Accounting Working Group<sup>46</sup> started an internal data gathering process aimed at describing how regulatory accounting systems were implemented in member states with respect to cost-orientation or non-discrimination obligations and/or to assist price control decisions.
104. The report was then updated in 2006 and 2007 in order to monitor the level of harmonisation in regulatory accounting systems across Europe. The 2006 and 2007 reports showed a trend towards an increasingly harmonised approach to regulatory accounting obligation among European countries.
105. The following illustration, taken from the 2008 European Regulators Group (ERG) report titled “Regulatory Accounting in Practice 2008”,<sup>47</sup> shows an example of the accounting methodologies used for costing unbundled local access services across 22 different countries. According to this data 95% of jurisdictions prescribe a particular form of accounting to measure the cost for this service. The majority of these countries (73%) apply current cost accounting (CCA) to calculate a cost base<sup>48</sup>.



106. The ERG stated in its 2008 report that:<sup>49</sup>

...The data comparison confirms the important trends already observed in last years, that is to say a further consolidation in the use of Current Cost Accounting (CCA) as the preferred cost base for wholesale markets ... accompanied by an always more extensive use of Long Run Average Incremental Cost (LRIC/LRAIC) methodologies both in the fixed and in mobile wholesale markets.

### *Submissions*

107. The Draft Principles Paper presented the Commission’s preliminary view that:<sup>50</sup>

<sup>45</sup> Independent Regulators Group.

<sup>46</sup> See <http://www.irg.eu>.

<sup>47</sup> ERG, *ERG Report: Regulatory Accounting in Practice 2008*, September 2008, Figure 5, page 18, available at: [http://www.erg.eu.int/doc/publications/erg\\_08\\_47\\_final\\_ra\\_in\\_practice\\_081016.pdf](http://www.erg.eu.int/doc/publications/erg_08_47_final_ra_in_practice_081016.pdf).

<sup>48</sup> The CCA of the asset base for the network is often combined with the use of a forward-looking long run incremental (FL-LRIC) costing or accounting methodology.

<sup>49</sup> ERG, *ERG Report: Regulatory Accounting in Practice 2008*, September 2008, page 3, available at:

[http://www.erg.eu.int/doc/publications/erg\\_08\\_47\\_final\\_ra\\_in\\_practice\\_081016.pdf](http://www.erg.eu.int/doc/publications/erg_08_47_final_ra_in_practice_081016.pdf).

<sup>50</sup> Draft Principles Paper, para. 32.

... for the transitional year, assets are to be valued on the basis of historic cost, with supplementary reporting using a current cost methodology. In subsequent years, if a forward looking approach is adopted for regulatory purposes, it will be necessary to make greater use of a current cost methodology. However, at this stage it is envisaged that a historic cost methodology will provide the primary basis for asset valuation in the regulatory accounts. The historic cost methodology reduces compliance costs during the implementation period.

108. Telecom argued that the forward-looking costs (current costs) are relevant for making pricing, production, and investment decisions both in the present and in the future, while historical costs are not relevant, and accounts prepared using historical costs could be “misleading”.<sup>51</sup> Telecom stated that:<sup>52</sup>

Historic cost regulatory accounts are not appropriate to be used for the purposes of evaluating prices, and that comparisons cannot be made between asset values and the methodologies used for setting prices.

109. In particular Telecom considered that product statements based on historical cost should not be viewed as a mechanism to review the appropriateness of regulated prices. For practical matters and for the transition phase Telecom stated that “*regulatory accounts will need to value assets on an historic cost basis*”.<sup>53</sup>

110. Telecom proposed that the statement of assets be “*expressed in both historic (Gross and Net Book Value) and forward looking (Gross and Net replacement cost) terms be presented*”.<sup>54</sup>

111. NZ Communications stated in its submission that more detailed additional information, in particular on mobile services, should be included.<sup>55</sup> NZ Communications argued these disclosures should be made using forward-looking approaches. InternetNZ, quoting the ERG, commented that “*the suggested initial approach focuses on historical cost. This historical cost approach does not deliver appropriate regulatory outcomes*”,<sup>56</sup> and therefore:<sup>57</sup>

There is no need for a transitional year even for the proposed historical cost reporting, let alone current cost reporting. ...

As part of current cost accounting, which should be introduced quickly, Telecom should report information underpinning regulatory pricing (costs-oriented or retail minus, as appropriate). This provides first-order information on fulfilment of appropriate pricing.

112. InternetNZ suggested that if stakeholders are provided with “first order” information underpinning total service long-run incremental cost (TSLRIC) and retail-minus, the information would be valuable for several reasons, including:<sup>58</sup>

- A body of information will develop over time that will allow access seekers to assess whether to seek a determination or to go to the final pricing principle;

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<sup>51</sup> Telecom Draft Principles Submission, para. 56.

<sup>52</sup> *Ibid*, para. 57.

<sup>53</sup> *Ibid*.

<sup>54</sup> *Ibid*, para. 75.

<sup>55</sup> NZ Communications, *Submission to the Commission*, 18 July 2008.

<sup>56</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para 1.4.

<sup>57</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, paras 1.5 and 1.7.

<sup>58</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para 4.9.

- An access seeker could seek reconsideration based on changed circumstances since the price was determined;
- Access seekers and the regulator will be better informed when price re-emerges as an issue;
- The Commission will be able to instigate a Schedule 3 investigation, possibly following input from more informed stakeholders and the Minister;
- The public pressure that will be able to be brought to bear where the information shows a divergence between actual prices and what reports show is appropriate.

113. InternetNZ noted that CCA has been adopted by Ofcom and that the ERG considers CCA more appropriate for regulatory purposes.

*Commission View*

114. The Commission notes that there are several accounting treatments for asset valuations and that these can be used for different purposes.
115. The Commission's view is that the HCA standard will be useful to a wide range of users, as HCA allows a reconciliation so that all costs in Telecom's statutory accounts are fully allocated within the regulatory accounts. This will help to ensure the consistency and quality of the information.
116. As the HCA information is already prepared for statutory accounting purposes it is reasonable to require Telecom to disclose this information.
117. In addition, the Commission considers that some information should be prepared on a CCA basis. Vertically integrated firms such as Telecom provide a wide range of different services. Some of the inputs necessary to supply these services are subject to rapid technological change, and some of these services are subject to forms of entry by competitors. Therefore, CCA-based information will help third parties assess Telecom's efficiency. This is in line with submissions received.
118. Telecom has already undertaken a valuation of Chorus' assets prepared on a CCA basis, a copy of which was provided to the Commission. (The CCA valuation was submitted in addition to the Chorus statement prepared on an HCA basis, which was required by clause 104 of the Undertakings.) Whilst the Commission has not yet reviewed or approved that valuation or those Chorus Statement of Assets for compliance with these Requirements, the Commission notes that the use of CCA will not impose significant additional costs on Telecom.
119. The collection of two sets of information is also reasonable and useful to other parties as it assists with estimating the forward-looking long-run incremental costs (FL-LRIC) and stand-alone costs, which represents the upper and lower bounds within which the costs of the relevant products should fall.
120. In addition, reporting of both HCA and CCA information is consistent with the accounting separation practice in Europe, e.g., UK, and Australia.
121. The Commission considers, given the limited utility of HCA valuation for other than reconciliation purposes, and that Telecom has only disclosed HCA in the audited statutory accounts on a Group basis, that it would be unreasonable to require Telecom to provide HCA at a level disaggregated below Service Groups.

*Commission Decision*

122. The Commission considers that Telecom should provide information using both CCA and HCA for the Regulatory Statements of Financial Performance and the Regulatory

Statements of Mean Capital Employed, and for the Regulatory Statements of Fixed Assets. The Commission considers that at the product statement level, Telecom should use current cost methods only.

### **Attribution Methodology**

123. A significant proportion of Telecom's operational and asset costs, liabilities, and revenues relate to activities which support multiple services and/or across Services Groups. The method used to allocate or apportion these costs can have a material impact on reported profits and other financial results.
124. International best practice for regulatory accounting includes the development of methodologies which allocate costs, revenues, assets, and liabilities to individual services on a non-arbitrary basis. The ERG considers that attribution can be complex and has developed a set of principles for cost causality.<sup>59</sup>
125. The IRG considers that regulatory accounting guidelines will typically document the methods for attributing costs, revenues, assets and liabilities.<sup>60</sup>

### ***Terminologies and Definitions***

126. International best practice cost allocation approaches used by telecommunications regulators include:
- Fully Allocated Cost<sup>61</sup> (FAC);
  - Long Run Incremental Cost (LRIC); and
  - Stand Alone Cost (SAC)
127. *Fully Allocated Cost*. FAC is used to distribute all costs among a firm's various products and services. Through the implementation of FAC, costs can generally be grouped in following categories:
- **Directly attributable cost:** These costs can be directly and unambiguously incurred against services;
  - **Indirectly attributable joint and common cost:** These costs do not fall in the directly attributable category. These costs have an indirect relationship to a service, and can be allocated to an individual service based on the use of causal drivers like FTEs, space usage, etc. These costs may include horizontal and vertical shared costs like billing services, call centres, etc.; and
  - **Unattributable common costs:** These costs have no causal relationship to the services and need to be attributed on a non-causal basis.
128. FAC can be estimated on an historical cost or forward-looking efficient cost basis.
129. *Long-Run Incremental Cost*. Incremental cost concepts estimate the incremental costs that arise with a specific increment in volume of production, given a certain period. An increment is the unit of output over which costs are being measured. Incremental costs

<sup>59</sup> ERG, *ERG Common Position: Guidelines for Implementing the Commission Recommendations C (2005) 3408 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications*, page 6.

<sup>60</sup> IRG, *Principles of implementation and best practice regarding accounting separation and cost accounting, as decided by the Independent Regulators Group*, November 2002, p 4-5.

<sup>61</sup> FAC is also referred to as Fully Distributed Cost (FDC).

are the costs that are caused by providing a defined increment of output given that some level of output is already being produced or alternatively the costs avoided when stopping the supply of the respective service. In telecommunications, incremental costs are often estimated by taking the increment over the entire service being supplied.

130. Forward-looking cost methodologies are a subset of the cost allocation approaches outlined above. The measure of long-run costs captures the idea that it is possible to vary the level of capital in the supply of any service. Therefore, the forward-looking long-run costs must include some expectation of a return of capital (i.e., depreciation) and an expected return on capital (i.e. through the weighted average cost of capital or WACC).
131. As the long-run incremental cost in telecommunications is typically estimated using forward-looking costs and done over the entire increment of the service, it is technically a forward-looking long-run average incremental cost (FL-LRAIC) that is calculated. Nevertheless, the estimate is described by most European regulators as simply a “LRIC” estimate, as the average and forward-looking nature of the estimate are assumed.
132. *Stand Alone Cost.* The stand alone cost concept includes the forward-looking long-run incremental cost estimates (LRIC) relevant to the specific increment in volume of production, along with 100% of the forward-looking joint and common costs. The stand-alone costs provide an upper bound on the allocation of the common and joint costs.<sup>62</sup>

### ***International Best Practice***

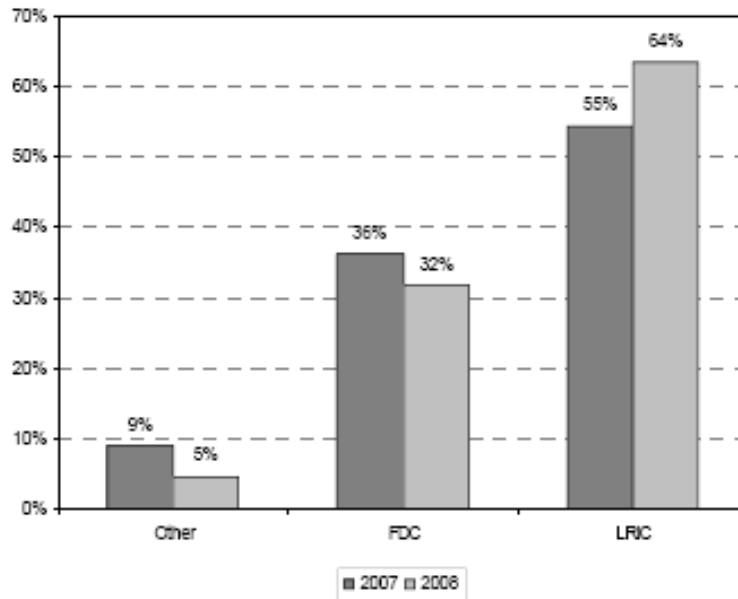
133. Incremental cost standards for estimating service costs are widely used across different jurisdictions and different sectors. The ERG<sup>63</sup> provided an overview in 2008 of the accounting allocation principles for different telecommunication services. The following diagram from the ERG report<sup>64</sup> shows the example of unbundled wholesale access, and the principles applied across 22 different jurisdictions.

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<sup>62</sup> Stand-alone costs do not necessarily represent a cost-causal allocation within a broader economic range, since they do not recognise the economies of scale an integrated firm experiences. Stand-alone costs should not be applied repeatedly across activities, because this can result in over-recovery of common costs.

<sup>63</sup> ERG, *ERG Report: Regulatory Accounting in Practice* 2008, September 2008, available at: [http://www.erg.eu.int/doc/publications/erg\\_08\\_47\\_final\\_ra\\_in\\_practice\\_081016.pdf](http://www.erg.eu.int/doc/publications/erg_08_47_final_ra_in_practice_081016.pdf).

<sup>64</sup> *Ibid*, Figure 6, page 19.



134. Several overseas regulators have implemented ERG's principles for cost causality. The ERG considers:<sup>65</sup>

The principle of causality implies that costs are allocated, directly or indirectly, to the services that "cause" the costs (and revenues) to arise. This requires the implementation of appropriate and detailed cost allocation methodologies.

In practice, this requires that operators:

- Review and justify the relevance of each item of cost, capital employed and revenue;
- Establish and quantify the factor or "driver" that caused each item to arise; and
- Use the driver to allocate each item to individual businesses/activities/network components or services.

### *Use of FAC*

135. Both Draft Papers presented the preliminary view that Telecom should adopt FAC when preparing section 69ZB information.

### *Submissions*

136. No submission challenged the overall need for cost allocation, but there were differences over how FAC should be implemented.

137. InternetNZ submitted that a detailed approach to cost allocation was needed and that it could be implemented quickly, including full reporting for the 2008/09 reporting year. In reaching this position, InternetNZ noted that as T&SS formed a large part of Telecom's business, inappropriate allocations between T&SS and other business activities could "materially distort the position" and considered:<sup>66</sup>

It is inevitable that it will be necessary for the Commission to impose specific guidance and requirements for Telecom, given the scale of shared cost which is to be allocated, and the

<sup>65</sup> ERG, *ERG Common Position: Guidelines for Implementing the Commission Recommendations C (2005) 3408 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications*, page 6.

<sup>66</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para. 5.4.

ability for this to be allocated, as the Commission notes, in a way that is favourable to Telecom's position.

#### *Commission View*

138. Under the FAC system the total costs incurred by the service provider are allocated across services. Further, applying FAC on the basis of statutory historical costs is consistent with the audited statutory financial statements produced by Telecom. By providing statements on a consistent basis, interested parties can compare and assess both regulatory and statutory accounts. This will increase confidence in the reliability of the information.
139. In telecommunications, a significant share of input costs are common or joint to various services being supplied, e.g., trenches, ducts, and cables to provide broadband and voice services. Some costs can be allocated directly, others only indirectly. Costs which can be allocated directly have a unique causal driver and thus are not of particular concern to the Commission. On the other hand, costs that are shared across activities and services, or business units often have multiple drivers and therefore require careful consideration.
140. The FAC approach and the cost causality principle alone do not provide a definitive single approach to allocating joint and common costs. The selection of cost causal drivers to allocate joint or common costs is often a matter of judgement. A number of drivers may satisfy the causal criterion, but their application could result in materially different allocated costs across services. For instance, electricity invoices may be allocated on the basis of staff numbers, or the space occupied. Both of these drivers could be considered causal. However, the electricity costs allocated to the service in the two cases could be significantly different.
141. Furthermore, joint and common costs are often cascaded through various stages of allocation before they are finally allocated to a specific service. At each stage, a judgement is required as to the appropriateness of the drivers. For instance, billing costs may initially be allocated to a Services Group (Network, Wholesale, or Retail), then to a group of services (voice), and finally to a particular service (residential line rental).
142. A systematic bias towards the upper end of the range may result, for example, in the over recovery of common costs on regulated services. In an environment where there are multiple regulated services, at horizontal and vertical levels, the over recovery could be many times the cost of providing regulated services as a whole.
143. Therefore, the Commission considers that direct prescription of certain aspects of the application of the FAC approach may be necessary.

#### *Commission Decision*

144. The Commission requires in clause 17.2 of the Requirements that Telecom include the FAC methodology in the manuals to be used in preparing information disclosure under section 69ZB.
145. For the 2008/2009 financial year, Telecom will prepare the manuals according to this methodology. The Commission will review the implementation of this methodology. The Commission may prescribe specific details regarding the methodology for the 2008/2009 or the 2009/2010 financial years, and may issue specific requirements as to application if it deems necessary. As explained later in this paper the Commission is prepared to issue further requirements or amend the existing requirements if the cost causality principles are not applied as intended in the manuals.

## Overall Reasonableness of the Requirements

146. Telecom raised three issues regarding the reasonableness of the requirements that require additional consideration, and do not fall clearly within the other issues considered in this paper by the Commission. They are:

- The cost of implementing the requirements,
- The time required to implement the requirements, and
- The compatibility of existing Telecom systems with the requirements.

147. The Act also requires that the Requirements are reasonable having regard to the confidentiality of the information. The confidentiality of information is discussed later in this paper.

### *Cost of implementation*

#### *Submissions*

148. Telecom argued that:<sup>67</sup>

...Telecom considers that it would be unreasonable for the Commission to expect Telecom to incur the time and resources needed to deliver the Commission's requirements.

149. In support of this argument, Telecom commissioned a report by Pricewaterhouse Coopers LLP UK (“**PwC**”), which estimated the cost to Telecom over the first two years to be in the range of \$13 to \$26.75 million, which included the cost of external audit and the preparation of the manuals.<sup>68</sup>

150. PwC also asserted that the Draft Notification did not provide full details on several issues such as the number of services requiring product statements and the transparency of the manuals.<sup>69</sup>

151. InternetNZ, however, was “strongly” supportive of the proposed disclosure requirements in general, and suggested that the requirements should go further in several cases such as the inclusion of non-financial information and material relating to imputation tests (e.g., price squeeze), NGN plans, and making some of the compliance monitoring information public.<sup>70</sup>

152. InternetNZ considered that the Commission should draw on overseas experience and documents in developing and implementing robust requirements.

153. InternetNZ submitted that regulatory reporting will benefit end-users and the economy and identified benefits in having detailed information disclosure. InternetNZ considered that the cost is justified given the size of the market and potential benefits from improved competition and “substantially outweigh Telecom’s costs of disclosure”.<sup>71</sup>

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<sup>67</sup> Telecom Draft Notification Submission, para 32.

<sup>68</sup> PwC, *Review of Costs to Implement Accounting Separation and Regulatory Reporting Requirements*, 9 December 2008, page 4.

<sup>69</sup> *Ibid*, page 9.

<sup>70</sup> InternetNZ, *Submission to the Commerce Commission on Draft Notification of Information Disclosure Requirements*, 7 November 2008, page 2-3.

<sup>71</sup> InternetNZ, *Submission to the Commerce Commission on Draft Principles and Regulatory Reporting Requirements*, 21 July 2008, para 1.2.

*Commission View*

154. In determining the reasonableness of the requirements for the 2009 and 2010 financial years, the Commission has given regard to the following considerations:
- the utility of the information requested to interested parties;
  - Telecom's agreed migration plan, which will introduce new technology platforms, and will makes some services obsolete while introducing other new ones;
  - Telecom's current ability to comply with a full scale accounting separation regime;
  - other stakeholders' interest in an early implementation of accounting separation; and
  - the extent to which various disclosure requirements will promote competition for the long-term benefit of end-users.
155. At a high level the Commission considers that its requirements are reasonable and notes that overseas regulators have often adopted similar requirements. For example, in their report PwC noted that in the UK there are requirements for regulatory manuals, publication, attribution principles, product statements, regulatory financial statements, and ongoing independent audits, all of which are or have equivalents in the Commission's requirements. The UK and Ireland have implemented robust information disclosure frameworks which specify both what information is required and how it is to be prepared.
156. Much of Telecom's argument about reasonableness was related to specific aspects of the Draft Notification, such as the content of financial statements, need for compliance monitoring, and the implementation milestones. The Commission's final view on these issues is discussed in the respective sections of this paper.
157. The Commission has rejected on the grounds of unreasonableness other proposals made in the submissions which would have increased Telecom's compliance levels. The Commission also revised its position on some issues to reduce Telecom's compliance effort and costs.
158. The Commission considers that the disclosure of regulatory financial information will offer benefits to end-users and the economy which justify the costs of disclosure. This information will reduce information asymmetry and assist the wide audience in making a range of decisions which promote competition. Given the size of the telecommunications market in New Zealand, and the role it plays in enabling economic activity, the Commission considers that these benefits can be significant.

*Implementation Effort and Cost*

159. The Commission considers that there are several factors which mean that the cost and effort required to implement and comply with the section 69ZB requirements will be less than what Telecom and PwC suggest.
160. The final requirements are less onerous than those presented in the Draft Notification. Having considered the submissions, the Commission has reduced the audit and assurance requirements, one of the most significant cost components, according to

PwC.<sup>72</sup> This will not only reduce the direct cost of the regulatory audit, but will also reduce Telecom's cost of preparing information in advance of the audits. Telecom's submission identified that reduced audit requirements were one way to reduce the time and effort required for compliance.

161. As noted by InternetNZ, considerable related material already exists overseas and this material and the experience gained can be drawn in applying common or similar principles in New Zealand. Hence, for example, the cost of developing the regulatory manuals which PwC estimated based on UK experience should in fact be less in New Zealand. Telecom has already drawn on overseas expertise in this area, with one example being the report PwC's London office prepared in response to the Draft Notification.
162. InternetNZ submitted that allocation rules can be developed expediently due to the availability of material from other regulatory contexts and Telecom's own management accounting processes. On developing the rules InternetNZ stated:<sup>73</sup>

However, many issues are already clear enough to allow refinement of the approach to allocation and causation. The Commission can either draft more detailed guidelines for comment, or invite Telecom to do so, again for comment. Like all companies, Telecom already does this exercise for its internal management accounting purposes, for each product and business unit. It will have been doing so for the new business units (e.g, Chorus and Wholesale) since it voluntarily moved to split those operations months before Separation Day (31 March 2008). Internal management accounts go a long way already.

Among other resources, the Commission and Telecom have the Ofcom material ... When dealing with implementation issues below we conclude that a detailed approach to allocation can be achieved quickly, including for the current financial year.

163. Telecom has advised the Commission that it has completed the implementation of a new activity based management accounting regime to better manage the performance of its business units in an operationally separated environment.<sup>74</sup> Telecom has also progressed the systems and information improvements that were planned for as part of both the Separation Undertakings and Telecom's Next Generation programme.
164. In addition, Telecom has voluntarily completed a major asset verification exercise, and is in the process of establishing current cost values for all assets to facilitate improved financial management under Operational Separation. The Commission initially proposed requiring only historical cost accounts would be prepared for accounting separation, and it was Telecom that first proposed CCA accounts.
165. The Commission developed the Requirements to leverage off Telecom's existing initiatives, and off its established systems and processes, as much as possible
166. Other information required for information disclosure purposes can be produced using Telecom's existing systems used to prepare statutory reports, meet SEC requirements, bill customers, and manage operational activities.
167. Hence the Commission considers that the additional cost and effort which Telecom will incur in complying with the Requirements is significantly less than Telecom and PwC suggest. This reduced work load will impact on both the timeline and the number of fulltime staff (or equivalents) required. The Commission anticipates that much of the

<sup>72</sup> PwC, *Review of Costs to Implement Accounting Separation and Regulatory Reporting Requirements*, 9 December 2008, page 5.

<sup>73</sup> InternetNZ, *Submission to the Commerce Commission on Draft Principles and Regulatory Reporting Requirements*, 21 July 2008, para 5.6.

<sup>74</sup> See paragraphs 165 to 167 below for a discussion of Telecom's ABM system.

ongoing compliance work related to information disclosure under section 69ZB will be done by the same people who prepare other forms of financial reporting.

### ***Use of Telecom's Existing Information Technology***

#### ***Submissions***

168. Telecom submitted that it was unclear if it could use its Activity Based Management (ABM) system, developed for its internal management purposes, for regulatory cost allocation. Telecom stated the Commission's methodology is different because:

... it does not appear to use a cascade of costs and assumes that costs are not shared (i.e. that there is a single driver for each cost). This means where costs are shared, or not able to driven to the cost object in the business unit on the basis of causality, there will need to be an allocation. An example of when this would happen is when a cost remains constant as volumes change.

169. In subsequent discussions with the Commission, Telecom has advised that their systems are capable of fulfilling the Requirements.

#### ***Commission View***

170. Telecom can adopt the method used in its current information reporting systems of allocating items to multiple objects. The methodologies adopted must be documented in the regulatory manuals.

### ***Conclusion***

171. The Commission considers that the Requirements fulfil the purpose and other statutory obligations contained in Part 2B of the Act, including the requirement in section 69Z for reasonableness.

## **6. REGULATORY REPORTING REQUIREMENTS**

172. The draft papers both presented the view that Telecom should prepare regulatory financial statements for the disaggregated business activities (Services Groups) and product statements for a limited range of services.
173. The Draft Notification specified the following regulatory reports:
- Regulatory Consolidated Statements of Financial Performance and Mean Capital Employed that shows a summary regulatory financial overview of the revenues, costs and mean capital employed in Telecom Service Groups (service groups are as defined in these requirements);
  - a separate Regulatory Statement of Financial Performance for each of the Networks, Wholesale (regulated services), Wholesale (commercial services), Retail, and Other Services groups;
  - a separate Regulatory Statement of Mean Capital Employed for each of the Networks, Wholesale (regulated services), Wholesale (commercial services), Retail, and Other Services groups;
  - a closing Regulatory Statement of Fixed Assets for each of the Networks, Wholesale (regulated services), and Wholesale (commercial services) service groups; and
  - product statements.

### **Regulatory Statements of Financial Performance**

174. In the Draft Report, the Commission proposed that Telecom provide regulatory statements of financial performance.
175. Regulatory statements of financial performance provide a key measure of performance and provide transparency of Telecom's overall behaviour. These statements provide a relative measure of the performance of Telecom's various business activities.

#### *Submissions*

176. Telecom and InternetNZ both generally agreed with the disclosure of statements of financial performance.

#### *Commission Decision*

177. Accordingly, the Commission requires Telecom to prepare Regulatory Statements of Financial Performance. These reporting requirements are contained in clauses 3 and 6 of the Requirements.

### **Regulatory Statements of Mean Capital Employed**

178. The Draft Principles Paper suggested that a regulatory statement of financial position (a balance sheet) be produced for each of the identified disaggregated entities within Telecom.
179. Following the submissions on the Draft Principles Paper, the Commission's preliminary position was amended in the Draft Notification to require Telecom to prepare Regulatory Statements of Mean Capital Employed for each of the Services Groups.

*Submissions*

180. Telecom submitted that statements of capital employed, similar to those required by other regulators such as BT and Eircom, should be produced instead of full statements of financial position.

*Commission View*

181. The Independent Regulators Group has highlighted the usefulness of statements of mean capital employed (“MCE”) to National Regulatory Authorities (“NRA”). The IRG says of MCE:

NRAs and operators will be concerned with average capital employed during any period rather than with capital employed at a single point in time such as the end of the financial year. This is because a “snap-shot” at any one point in time may not be representative of the average level of capital employed by operators. Specifically, working capital balances at a single point in time may not be representative of average working capital requirements over an extended period. The separate accounts of operators should therefore show average capital employed, rather than year-end balances... .

182. Regulatory statements of mean capital employed are an estimate of the capital base. It is a tool commonly used by industry analysts to assess returns on the historical cost of investments. This enables financial performance information to be accessible to a wide range of people, and to be readily compared to the return on other assets.
183. The requirement for the capital employed statements will be reviewed after the 2009/10 reporting period as the regulatory reporting under accounting separation moves toward a forward looking economic approach.

*Commission Decision*

184. The Commission considers that Telecom should prepare Regulatory Statements of Mean Capital Employed on an historical cost and current cost basis for the 2008/2009 and the 2009/2010 financial years. These disclosure obligations are contained in clauses 4 and 7 of the Requirements.

**Regulatory Statements of Fixed Assets**

185. Both draft papers presented the preliminary view that regulatory statements of fixed assets should be disclosed.

*Submissions*

186. The Commission received no substantive submissions to the contrary. Telecom included statements of assets in its proposal in its response to the Draft Notification.

*Commission View and Decision*

187. Regulatory statements of fixed assets provide a measure of the value of the assets employed in the provision of various services. As Telecom’s Services Groups, particularly the Wholesale and Network Services Groups, control substantial capital investments, a wide range of people will consider this information relevant to determining the efficiency of Telecom’s investments, which will further industry investment and promote dynamic efficiency.
188. Accordingly, the Commission requires that Telecom should prepare Regulatory Statements of Fixed Assets. These reporting requirements are contained in clauses 5 and 8 of the Requirements.

## Consolidation and Reconciliation

189. Both draft papers presented the preliminary view that Telecom must consolidate the regulatory financial statements and reconcile the consolidated statements to the financial statements published in its Annual Report, and to explain any variations .
190. The ERG recommends that a regulator require reconciliation when developing regulatory accounts so as to avoid double counting of costs.<sup>75</sup> Similarly, the Commission of European Communities (the EU) states that:<sup>76</sup>

For consistency and data integrity, it is recommended that the financial reports of the regulatory accounts be consolidated into a profit and loss statement and a statement of capital employed for the undertaking as a whole. A reconciliation of the separate regulatory accounts to the statutory accounts of the operator is also required.

### *Submissions*

191. Telecom and InternetNZ both supported the use of reconciliation to provide assurance as to the quality of the regulatory reports. Telecom's submission proposed templates for the reconciliation of a regulatory statement of capital employed and financial performance statements to the statutory accounts.
192. InternetNZ's cross-submission supported the use of reconciliation to the statutory accounts and provided some specific comments from the European Regulatory Group (ERG) on how aspects of the consolidation could be performed and the need for controls such as reconciliation.<sup>77</sup> InternetNZ maintained that failure to do this could result in costs which should be charged to a non-regulated service being charged to a regulated service. Such changes can lead to competition concerns in the regulated service market, increases in prices, and decreases in efficiency.

### *Commission View*

193. The reconciliation process can identify (and allow time to correct) any errors in financial statements. The publication of the reconciliation statements provides readers with information about the reliability of the information.
194. The Commission's view is that reconciliation is an important requirement to reduce the risk of systematic bias leading to cross-subsidisation, and in promoting and demonstrating the integrity of the regulatory accounts. The Commission also considers that a large corporation, such as Telecom, should have the financial systems in place to ensure that its financial data reconciles and to allow it to prepare regulatory reconciliation statements at a reasonable incremental cost.

### *Commission Decision*

195. The Commission considers that Telecom should be required to consolidate the Regulatory Statement of Financial Performance, the Regulatory Statements of Mean Capital Employed, and the Product Statements. This requirement is contained in clauses 3, 4, 6, 7 and 9 of the Requirements. In addition, the Commission considers that

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<sup>75</sup> ERG, *ERG Common Position: Guidelines for implementing the Commission Recommendation C (2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications*, ERG (05) 29, page 3:

[http://erg.eu.int/doc/publications/consult\\_accounting\\_sep/erg\\_05\\_29\\_erg\\_cp\\_rec\\_as\\_and\\_cas\\_final.pdf](http://erg.eu.int/doc/publications/consult_accounting_sep/erg_05_29_erg_cp_rec_as_and_cas_final.pdf).

<sup>76</sup> Official Journal of the European Union: Commission recommendation of 19 September 2005 on accounting separation and cost accounting systems under the regulatory framework for electronic communications.

<sup>77</sup> InternetNZ, *Further Submission to the Commerce commission on Draft Principles and Regulatory reporting Requirements for the Accounting separation of Telecom* 15 August 2008, page 17.

Telecom must reconcile the consolidated statements to the financial statements published in Telecom's Annual Report, and explain any variations. This requirements is contained in clauses 10 and 11 of the Requirements.

### **Product Statements**

196. The Draft Principles Paper presented the preliminary view that product statements should be required from Telecom for the designated access service interconnection with Telecom's fixed PSTN and for other key regulated services.
197. Product statements are useful for promoting competition within a Telecom information disclosure regime because they provide the audience with the means to determine whether:
- regulated services are cost-based or cost-oriented;
  - Telecom's non-discrimination obligations are being met; and
  - Telecom is achieving appropriate levels of profitability.
198. Product statements can also promote competition by providing other parties, such as access seekers and access providers, with sufficiently detailed information about services to determine whether to make use of the regulatory system. For example, access seekers can form a view as to whether to seek a pricing review of a regulated price set through international benchmarking.

### *Submissions*

199. Telecom submitted that that there should be no product statement for PSTN Interconnection as:<sup>78</sup>
- ... the commercial arrangements in place are effective and efficient. ... If a product statement were to be required, it would seem appropriate to request similar disclosures from access providers of the designated access service of interconnection with fixed PSTN other than Telecom's.
200. NZ Communications in its cross submission stated that:
- ... requiring a sufficiently granular product statement, along with disclosure of contract terms and other information will enable transparency, help redress the asymmetry, and encourage quicker resolution of issues between access seekers and other providers.
201. InternetNZ submitted that if product statements are going to be limited to regulated services, the services should include each bitstream variant, LLU, and backhaul for those services. In the future InternetNZ believe that the Commission should consider having product statements for some services that are not regulated. InternetNZ also considered that one-off charges should be reported, as they can have a discriminatory effect.
202. NZ Communications submitted that separate statements should be provided for mobile services which are or could be wholesaled.

### *Commission View*

203. Product statements are a standard tool for identifying whether or not prices are cost-based, and for assessing the profitability of a particular service.
204. The Commission considers that product statements are required for the services listed in the Requirements for the financial year ending June 2010. As part of the consolidation

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<sup>78</sup> Telecom Draft Principles Submission, para. 63.

of these statements Telecom will also be required to provide an aggregated view of the services. This will enable the product statements to be fully reconciled at the aggregate level.

205. Many access seekers interconnect with Telecom's fixed voice services (currently PSTN). As voice services are a significant share of the costs and revenues of Telecom and the vast majority of other telecommunications service providers, the ability to interconnect is fundamental to competing in key markets such as local access and calling. While there are currently commercial arrangements in place, voice interconnection is a designated service, and is one of a number of strategic bottlenecks. Disclosure of information on such services will therefore promote competition.
206. The Commission considers that information on interconnection with Telecom's fixed PSTN should be disclosed because of the service's critical role in telecommunications market competition. This is consistent with the scope of the product statements to cover all services which are specified in the Act.
207. The Commission does not think it appropriate at the present time to request the disclosure of information regarding fixed PSTN interconnection from other service providers (under an exercise of the Commission's section 69ZC powers). However, the Commission considers that this does not negate the current benefits of having disclosure on interconnection with Telecom's fixed PSTN. In particular the Commission notes that Telecom (by virtue of the size of its fixed PSTN) is the largest provider of fixed PSTN interconnection in New Zealand and in many areas of New Zealand the only provider of fixed PSTN interconnection. Hence there is likely to be greater interest in (and hence benefit from disclosure) of details about interconnection with Telecom fixed PSTN.
208. The Commission does not consider that requiring product statements for specific mobile services would be appropriate at this time.
209. Due to the changing nature of the telecommunications market, the Commission anticipates that the choice of services covered by the product statements will change over time. However, the choice will be driven by a focus on regulated services, as these reflect the bottlenecks and markets of concern. Such changes are in keeping with the purpose of Part 2B.

#### *Commission Decision*

210. The Commission requires for the financial year ending June 2010 that Telecom prepare the product statements listed in Appendix F of the Requirements paper. The product statement disclosure requirements are contained in clause 9 of the Requirements.

## 7. COMPLIANCE MONITORING REQUIREMENTS

211. Along with the information disclosure requirements under section 69ZB, the Commission expects to issue a letter obliging Telecom to provide certain compliance monitoring information to the Commission under section 69ZF(1)(b).
212. Section 69ZF(1)(b) authorises the Commission to require Telecom to supply information solely to the Commission for the purpose of monitoring Telecom's compliance with the Requirements.
213. The Draft Notification included a preliminary view that further information for the purposes of monitoring Telecom's compliance with the regulatory reporting requirements should be provided to the Commission pursuant to section 69ZF(1)(b). This information will be supplied to the Commission and will not be publicly disclosed.
214. The Draft Notification proposed the following compliance monitoring requirements:
- detailed Regulatory Statement of Fixed Assets;
  - Regulatory Statement of Capital Investment;
  - a Schedule of Network Components and a Network Activity information;
  - standalone (ceiling) and variable only (floor) unit cost data for each service that requires a product statement; and
  - other information to enable the Commission to monitor the application of the attribution methodologies and to give transparency to efficiency and non-discrimination objectives in the Act.

### *Submissions*

215. Telecom submitted that “*each of the pieces of compliance monitoring information is unnecessary*”, and the “*Commission's request for compliance monitoring information is ... unreasonable*”.<sup>79</sup> Telecom argued that the costs associated with providing the information, including the detailed Statements of Capital Investments, outweigh the benefits.
216. Telecom was also of the view that it was not appropriate to use compliance monitoring information for operational separation purposes.
217. Telecom argued that the compliance monitoring requirements were unreasonable and unnecessary.<sup>80</sup>
218. Telecom specifically questioned the purpose of producing compliance monitoring information if the information was not provided to a “wide range of people”.<sup>81</sup> In an earlier submission, Telecom argued that disclosing this information will put it at an unreasonable competitive disadvantage as detailed capital investment information, produced on an annual basis, would be very valuable to its competitors.<sup>82</sup> Telecom considered that the proposed statement of capital employed and statement of assets provide adequate information on assets.<sup>83</sup>

<sup>79</sup> Telecom Draft Notification Submission, para. 53-54.

<sup>80</sup> *Ibid*, para. 4, 53-57.

<sup>81</sup> *Ibid*, para. 4.

<sup>82</sup> Telecom Draft Principles Submission, para. 75.

<sup>83</sup> *Ibid*.

219. InternetNZ strongly endorsed the Commission's proposed disclosure requirements and submitted that the Commission should err on the side of disclosure. For example, InternetNZ considered the ceiling and floor unit cost data should be disclosed.<sup>84</sup>
220. InternetNZ's cross submission expressed concern about Telecom's resistance to disclose its capital investments. They considered that this information is needed to enable access seekers to adequately participate in consultation with Telecom. InternetNZ considers it is appropriate (and within the Act's objectives) to require sufficient information disclosure to enable adequate consultation, as required by the Undertakings.

#### *Commission View*

221. The Compliance Monitoring information provides a mechanism to test the reliability of the information provided under section 69Y.
222. Compliance monitoring information is essential for the Commission to ensure that both the process and the published data are robust and complete. The compliance monitoring information allows the Commission to test for compliance with the requirements.
223. The Commission considers that this increased level of assurance will benefit the wide audience as it will both improve the quality of information published, and will provide the wide audience with increased confidence in the quality of the public information.
224. The Regulatory Statement of Capital Investment has been renamed as a Regulatory Statement of Asset Movement. This is to clarify that the statement should include deductions from assets including depreciation, as well as additions to assets such as capital investment. The Regulatory Statement of Asset Movement is required to provide transparency to asset adjustments during the year, determining the validity of any asset additions and deductions, and future asset movements. In the Commission's view, the additional clarity this provides outweighs the costs.
225. The Detailed Regulatory Statement of Fixed Assets will enable the Commission to check compliance of not only the asset statements but also the attribution process by providing visibility of one of the major costs.
226. The Schedule of Network Components and Network Activity information will allow the Commission to determine the accuracy of product statements by providing the Commission with information regarding significant network components contributing to various services.
227. The stand-alone cost (ceiling) and long run incremental cost (floor) estimates for services, using forward-looking cost data, provides the likely ranges in which Telecom's prices should fall in the absence of cross-subsidisation. It will therefore help the Commission determine whether the allocation methodology has been appropriately applied.

#### *Commission Decision*

228. The Commission maintains the view that in relation to publicly disclosing information under section 69ZB, Telecom should provide compliance monitoring information. The Commission expects to issue specific requirements under section 69ZF(1)(b) similar to the preliminary compliance monitoring requirements contained in clause 18 of the Requirements.

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<sup>84</sup> InternetNZ, *Submission to the Commerce Commission on Draft Notification of Information Disclosure Requirements*, 7 November 2008, page 2-3.

## 8 OTHER ISSUES

229. The following section presents the Commission view on other provisions in the Requirements, and on additional matters raised in submissions.

### Use of Generally Accepted Accounting Practice (GAAP)

230. The accounting profession has developed comprehensive standards, commonly known as GAAP, which are accepted internationally. Telecom, like other listed New Zealand corporations, is required to prepare its financial statements in accordance with the Financial Reporting Act 1993, which requires preparing accounts in accordance with New Zealand GAAP.<sup>85</sup> As Telecom is listed on the NYSE as well as the NZX and ASX, Telecom also prepares accounts in accordance with US GAAP.
231. However, many accounting practices, such as the choice of depreciation profiles or the selection of a metric for Activity Based Costing (ABC) cost allocation, have a degree of choice which can materially impact the quality, reliability, and usefulness of the information disclosed. In addition, GAAP does not prescribe an approach for some methodologies, such as valuing assets using current cost accounting, which are often used for regulatory purposes. Hence there is a limit to the extent to which regulatory accounts can rely on GAAP.
232. The Draft Notification presented the preliminary view that Telecom should conform to NZ GAAP when disclosing accounting information under section 69ZB unless the Commission issues alternative specific requirements.

### Submissions

233. Most submissions did not comment specifically on the use of NZ GAAP. InternetNZ noted the limitations of GAAP in its submission:<sup>86</sup>

T&SS raises the question of whether the Commission should move sooner than later to refine allocation and causation issues beyond the currently proposed application of NZ GAAP principles, and subsequent approval by the Commission of Telecom's methodologies.

GAAP provides relatively wide ranging principles. It is inevitable that it will be necessary for the Commission to impose specific guidance and requirements for Telecom, given the scale of shared cost which is to be allocated, and the ability for this to be allocated, as the Commission notes, in a way that is favourable to Telecom's position.

### Commission View

234. The Commission considers that it should prescribe specific requirements for a number of areas where NZ GAAP does not provide an approach appropriate for fulfilling the purposes of the Act. These are discussed throughout this document, and are particularly addressed in the discussion of accounting standards, *supra*.
235. It would be a time consuming and costly process for the Commission to develop a reporting framework which addressed every aspect of information disclosure. It would also increase Telecom's ongoing compliance and monitoring costs.
236. The Commission also considers that NZ GAAP takes advantage of a widely adopted existing financial framework that is used by Telecom, and thus will reduce the need to

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<sup>85</sup> This includes the New Zealand equivalents to International Financial Reporting Standards (IFRSs) and Financial Reporting Standards (FRSs).

<sup>86</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para 5.3-5.5.

develop and implement accounting policies for many items. This should reduce Telecom's compliance costs and allow Telecom to prepare the information disclosure in a more timely manner. During the initial years of information disclosure under section 69ZB, NZ GAAP also offers the benefits of an existing default standard.

#### *Commission Decision*

237. The Commission considers that Telecom should adhere to the New Zealand accounting standards (NZ GAAP) when disclosing accounting information, unless an express direction has been given elsewhere in the Requirements.

### **Publication Requirements**

238. The Act states that the information disclosed must be reliable, timely, and inform a wide range of people. The NZ accounting profession has issued a framework paper which sets out the qualitative characteristics of financial statements.<sup>87</sup> This paper considers the four principal qualitative characteristics as understandability, relevance, reliability and comparability.<sup>88</sup> Timeliness is seen as being a constraint on relevance and reliability in that if there is undue delay in reporting, information may lose its usefulness, even if reliability is improved. Consistency across both time and reporting entities is seen as an attribute of comparability.<sup>89</sup>
239. Due to its statutory reporting obligations, Telecom is already required to adhere to the qualitative characteristics of financial reports specified by the New Zealand accounting profession in the paper.
240. In the Draft Principles Paper and Draft Notification, the Commission presented the preliminary view that for the purposes of these regulatory requirements, Telecom's information disclosure should adhere to the accounting profession's qualitative characteristics of financial reports. The Draft Paper noted that the use of consistent methodologies will aid comparability of the disclosed information over time and between Telecom's business units. It also reduces the likelihood of situations where a change of accounting practices can artificially change reported costs.

#### *Submissions*

241. Most submissions did not comment specifically on the qualitative characteristics. The MED's submission supported the Commission's preliminary view on the qualitative characteristics of financial statements, and emphasised the need to ensure consistency of reporting between Telecom's business units.<sup>90</sup> Consistency was seen as important for enabling reconciliation across business units.

#### *Commission View*

242. The Commission considers that adherence to the accounting profession's qualitative characteristics of financial reports will help meet the requirement in the Act that the information disclosed under sections 69ZB is reliable, and informative to a wide range of people.

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<sup>87</sup> FRSB of NZICA, *New Zealand Equivalent to the IASB Framework for the Preparation and Presentation of Financial Statements*, June 2005.

<sup>88</sup> *Ibid*, F.24.

<sup>89</sup> *Ibid*, F.39, F.40.

<sup>90</sup> MED, *Submission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 18 July 2008, p.2.

243. In particular the Commission considers that the methodologies applied should be consistent between periods and across activities and that the effect of any change of methodology be disclosed. This will aid comparability of the disclosed information over time and between Telecom's business units.
244. As this principle is consistent with existing statutory reporting obligations, it should not cause significant additional compliance costs.

*Commission Decision*

245. The Commission considers that Telecom should adhere to the accounting profession's qualitative characteristics of financial reports when preparing information requested under sections 69ZB. This obligation is incorporated by clause 14.2 of the Requirements.

**Transfer Charging (Trading Arrangements)**

246. Transfer charges are the transactions that flow between Telecom's Service Groups. They include both services which are supplied to competitors, and services which are only used by other parts of Telecom. Such services may have explicit prices (e.g. prices set by the Commission's standard terms determinations) or there may not be an explicit price.
247. The Draft Principles Paper presented preliminary views on the attributes of transfer charges.
248. The Draft Notification presented the preliminary requirements for the accounting treatment of transfer charging:

Where there is an arm's length, documented, arrangement in place for a Telecom group to supply another with services, then income from the resulting transactions should be recorded as internal revenue in the financial statements. As set out in the Undertakings, these trading arrangements should include terms of supply including a price or transfer charge.

Where there is no arm's length documented arrangement for the supply of internal services but the attribution methodology requires (for instance) all costs from a support group like T&SS to be attributed to market facing activities or to network components, then these costs need to be charged in accordance with the cost attribution methodology detailed in Appendix E.

*Submissions*

249. Telecom's submission on the Draft Principle's paper argued that that under Operational Separation the Commission will already have access to the agreements setting out the terms of supply for transfer charges and proposed to provide a schedule showing the total dollar amount of internal charges each business unit billed the other business units.<sup>91</sup> Telecom also proposed that the Commission should only approve the methodologies relating to transfer charges for those services for which product statements are required.<sup>92</sup>
250. In its cross-submission on the Draft Principle's paper, InternetNZ argued that disclosure of the terms of supply of the transfer charges is inadequate for regulatory purposes. InternetNZ argued that more detailed disclosure is required in order to address issues such as the use of overly favourable accounting policies, the appropriateness and

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rationale of the transfer charge and whether the charges have the effect of causing discrimination or cross-subsidies.

251. InternetNZ also considered that information on transfer charging should be publicly available to minimise problems such as the use of overly favourable accounting practices.<sup>93</sup> InternetNZ cited the ERG guidelines which consider that well defined transparent and verifiable transfer charging systems are necessary for regulatory accounting.<sup>94</sup>
252. The submissions on the Draft Notification paper did not specifically comment on the accounting treatment of transfer charges.

*Commission View*

253. The Commission considers that it is important to have transparency as to the attribution of transfer charges be Telecom's Services Groups.
254. Income from arm's-length, documented, arrangements is recorded as internal revenue (or an internal purchase) in the regulatory financial statements is consistent with the Act's requirement for presenting information as if the service groups were independent or unrelated companies. This approach will help promote non-discrimination and should decrease the risk of overly favourable accounting policies disadvantaging access seekers. These prices are often set by the Commission's access determinations or procedures governed by the operational separation Undertakings.
255. In the absence of an explicit price, transfer charges should be attributed in the same way as other attributed transactions reported under accounting separation. The use of a common cost allocation methodology (FAC) will ensure consistency of accounting treatment and avoids duplication of cost and effort. This approach ensures that the costs and revenues are matched to the activities incurring the costs and earning the revenues. This is important for identifying whether prices are cost-orientated (and this reducing the risk of cross-subsidies). The attribution rules used for recording these transfer charges will be specified in the Manuals.
256. The Commission considers that all transfer charges should be covered by either of the above two principles. Transparency of the internal trades will allow interested parties to better evaluate the operations and behaviour of Telecom's Services Groups, and will ensure that the information disclosed reflects Telecom's business activities, as if they were performed by independent or unrelated companies.

*Commission Decision*

257. The Commission does not consider it appropriate at the current time to approve actual transfer charges. The Commission only requires that Telecom record transfer charges, and that the process for doing so be described in the published manuals. Transfer charges are addressed in clause 13.2 of the Requirements.

**TSO Information**

258. The MED submission proposed the inclusion of TSO Local Service information in the regulatory reporting requirements. Their proposal included reporting of the TSO Local Service via its own product statement, and the disclosure of information separately
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identifying capital expenditure relating to the TSO Local Service. The MED considered that such information would be useful for policy purposes.

259. Telecom's cross-submission argued that Part 2B Information Disclosure was not the appropriate mechanism for disclosing TSO-related information. Telecom specifically noted the additional cost of providing such information and that Telecom already provides a considerable amount of TSO-related information to the MED and Commission.<sup>95</sup>

*Commission View*

260. The Commission's considers that the overall cost of providing a range of information for the TSO Local Service is high and may not be offset by the benefits over the information that is already available or that will become available through the information disclosure requirements.

### **Non-Financial Information**

261. InternetNZ submitted that information disclosure by Telecom should extend beyond financial information and gave several examples of information which it considered useful. This included disclosure of imputation tests for vertical and horizontal price squeeze, meeting non-price KPIs, and disclosure of information regarding forward-looking NGN plans.<sup>96</sup>

*Commission View*

262. The Commission considers that additional disclosure for 2009 and 2010 would add unreasonably to Telecom's current requirements and in some cases may raise questions about commercial confidentiality.
263. The accounting separation requirements for 2010 include product statements which will provide information which the wide audience could use to perform their own imputation tests. The Commission considers that this approach will provide sufficient information for the wide audience to form its own view on price squeezes for a range of key services.
264. The Commission notes that the operational separation undertakings include reporting on compliance with a number of topical non-price KPIs. At this stage the Commission considers that it would not be reasonable to require further such information disclosure.

### **Manuals**

265. The Draft Notification presented the Commission's preliminary view that for financial years ending 2009 and 2010:

Telecom must disclose the manner in which the methodologies prescribed by the Commission in accordance with sections 69ZB(5)(b) and (c) have been applied

266. The Draft Notification included a list of the minimum level of documentation that must be disclosed. This included an:

- Attribution Methodologies Manual;

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<sup>95</sup> Telecom Draft Principles Submission, pages 25-27.

<sup>96</sup> Internet NZ, *Submission to the Commerce Commission on the Draft Notification of Information Disclosure Requirements*, 7 November 2008, para 4.

- Asset Valuation Manual; and
- Accounting Policies Manual.

267. The Draft Notification also included a requirement for these manuals to be independently audited both initially and as part of the change management procedures.

#### *Submissions*

268. Telecom's submission on the Draft Notification did not specifically discuss the need for the manuals, but rather included the completion of the proposed manuals, their audit and revision in its proposed milestones.<sup>97</sup> Telecom has also provided the Commission with preliminary documentation of several of its accounting procedures.

269. PwC in a report commissioned by Telecom noted that in the UK, BT prepares manuals which "broadly equate to the scope of documentation proposed by the Commission".<sup>98</sup>

270. PwC expressed some concern that in 2010 there may be a need for significant amendment of the documentation given due to the increased level of regulatory reporting, but noted that the level of effort was linked to the number of product statements.<sup>99</sup>

#### *Commission View*

271. The Commission considers that the publication of manuals improves the transparency of the methodology used in preparing the financial statements. This will help the wide audience form an opinion as to the reliability of the regulatory statements and improve their understanding of the disclosed information.

272. Such transparency creates incentives for Telecom to ensure that the documented methodologies are externally justifiable. The documentation of methodologies can also improve consistency between reporting years and in the long term reduce the cost of external audit.

273. The ability to draw on existing manuals and expertise from overseas will reduce the compliance costs for Telecom. The Commission notes that in some instances Telecom could draw on existing documentation and procedures (e.g. from operational separation or other accounting practices) and that Telecom has already made progress in documenting its internal procedures for section 69ZB information disclosure. Telecom has already had to document its procedures for its CCA valuations and the implementation of its activity based costing system. These two systems, and the accounting policies that underpin them, are expected to support a significant component of the manuals. As such Telecom has the ability to prepare these manuals, and has access to resources which should reduce the effort required.

274. The Commission no longer requires that the manuals (or changes to the manuals) be audited by an independent regulatory auditor. This will reduce Telecom's compliance costs for both establishing the manuals and managing changes to the manuals in 2010 (the cost of the later being a concern raised in the PwC report).

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<sup>97</sup> Telecom Draft Notification Submission, Appendices A & B.

<sup>98</sup> PwC, *Review of Costs to Implement Accounting Separation and Regulatory Reporting Requirements*, 9 December 2008, page 7.

<sup>99</sup> *Ibid.*

*Commission Decision*

275. The Commission considers that Telecom must disclose the manuals used to prepare the financial reports.
276. During the initial financial year (2008/2009), Telecom will prepare the manuals in a manner consistent with the principles prescribed by the Commission.
277. The Commission recognises, however, the need to closely monitor the development of these manuals and methodologies in order to ensure they will provide information in furtherance of Part 2B. If it deems it necessary or appropriate to do so, the Commission will undertake to prescribe specific manuals or methodologies contained within the manuals.
278. The Commission will consider whether to prescribe the manuals for the financial year ending 2010 following a review of the manuals prepared during the 2008/2009 financial year.
279. In addition, should the Commission consider that Telecom has not applied the cost causality principle as required in the manuals, the Commission will either issue further requirements or amend the existing requirements to achieve the intended application of the cost causality principle.

**Retention and Availability of Information**

280. Section 69ZD(1)(f) authorises the Commission to determine for how long information must be disclosed, and section 69ZD(1)(g) authorises the Commission to require the retention of data on which the disclosed information is based.
281. Under New Zealand tax law, firms are required to retain information for seven years. The Commission expects that there will be overlap in the information used for tax and accounting separation purposes, and therefore considers that it is reasonable to expect Telecom to retain the accounting separation material for the same period as tax records.
282. The public availability of past financial information allows readers to assess trends over time, and to gain a richer view of a firm's activities and changes. Telecom currently has the last twelve annual reports available on its website. The Commission considers that the availability of past years' information will help inform the wide audience and that at least seven years information should be provided. This will allow sufficient information to be available to see longer term trends such as changes in capital investment or service mixes.

*Commission Decision*

283. The Commission requires Telecom to retain the data on which the disclosed information is based and associated documentation for at least seven years.
284. The Commission also requires Telecom to keep all reports, statements, or other information relating to accounting separation published on the available on the Internet for seven (7) years after the date on which the report or statement is first published.
285. These obligations are contained in clause 20 of the Requirements.

## 9. AUDIT AND ASSURANCE

286. Under section 69ZF(3)(a) the Commission may request that all or any of the information Telecom provides is audited. An audit is intended to verify that prescribed reporting methodologies have been implemented properly, improving the reliability of information, and increasing users' confidence in the information. Independent auditing of financial information is intended to identify and correct deficiencies in processes and information, and provide reassurance as to its reliability.
287. While Telecom's statutory financial statements are already subject to independent audit, some of the information required for regulatory purposes is not currently audited. This includes non-financial information that will be used for allocating costs and the reconciliation of regulatory accounts to statutory financial statements.
288. In the Draft Notification, the Commission presented the preliminary view that Telecom must engage an independent auditor(s) to review the information disclosed and that the audit scope should include information and processes which are not audited as part of the standard statutory reporting process.
289. The Draft Notification paper also included a preliminary audit scope which identified that the highest level of assurance was required for the regulatory financial statements, while a lower level of assurance was required for audits of the regulatory manuals. The Draft Notification presented the preliminary view that the auditor should owe a duty of care to the Commission.
290. The Draft Notification presented the preliminary view that the audit reports should be publicly disclosed. The publication of audit reports can provide incentives for firms to prepare information in a manner which ensures favourable audit opinions, and also informs the wider audience as to the quality of the regulatory reports.
291. The Draft Notification also included provisions for the appointment of an alternative regulatory auditor in the event that the first regulatory auditor proved to be unsatisfactory.

### *Submissions*

292. Telecom and InternetNZ both submitted on the audit process. No submission questioned the need for the regulatory accounts to be audited from 2009/10 onwards, but there were alternative views on the approach to the audit for 2008/09. Several aspects of the Commission's preliminary view, including the view that the regulatory auditor should owe a duty of care the Commission, were not specifically commented on.
293. InternetNZ in response to the Draft Principles Paper considered that auditing is essential and that it is important that the audit for 2008/09 includes a full review of the financial accounts down to product statements as well as the forward looking expenditure plans. InternetNZ considered that over time this detailed approach can be relaxed and cited the UK experience, where Ofcom has relaxed some audit requirements, in support of this option.<sup>100</sup>
294. Telecom submitted on many aspects of the Commission's preliminary view on auditing as presented in the Draft Notification including proposing reduced audit requirements for 2008/09 reporting year.

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<sup>100</sup> InternetNZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, page 14.

295. With regard to the ongoing level of audit assurance for the regulatory financial statements, Telecom submitted that having the audit completed to the “highest level of assurance” was unusual and not justified. Telecom rather proposed that the audit opinion be performed to the same level as Telecom’s statutory accounts.<sup>101</sup> Telecom’s statutory accounts for 2008 had a “fairly presents” level of audit assurance.<sup>102</sup>
296. Telecom in response to the Draft Notification proposed a lower level of assurance for 2008/09 (“properly prepared in accordance with”), and that materiality be set at the group level.<sup>103</sup> Telecom stated that these reduced audit requirements were justified due to the significant amount of learning for the auditor, Telecom and the Commission in the first year.
297. Telecom submitted that having the auditor provide draft audit reports to the Commission was unnecessary, adding time and cost to the process without any corresponding benefit.<sup>104</sup>
298. Telecom did not agree with the need to have provisions regarding the appointment of an alternative regulatory auditor.<sup>105</sup>
299. The PwC report raised a number of points regarding the level of assurance proposed in the Draft Notification paper. This included the effort needed to maintain the regulatory manuals to the level required to meet audit requirements for transparency, and the additional effort required to provide the high level of assurance (“fairly presents”) for the regulatory financial statements, and that this level of assurance would be impossible to provide for some product statements. PwC considered that the level of materiality for individual services would be small compared to the overall scale of Telecom, and hence the auditor would be unlikely to form a judgement over the reasonableness of methodologies to a high level of reassurance for a small individual service. PwC cited the UK experience, where the level of materiality for more detailed information has been a factor and where audit assurance requirements have been amended to reflect this.<sup>106</sup>

#### *Commission View*

300. The Commission considers that there is significant benefit in having an independent regulatory auditor review the regulatory financial statements, and in having the audit reports and recommendations publicly disclosed. Such a requirement would provide greater transparency and allows the users of the information to assess the degree to which the information meets the Act’s requirements for reliability.
301. The Commission also considers that there is benefit in having the auditor(s) report their findings to the Commission as this would enhance the accountability of the auditor to the Commission.
302. The audit scope will be reconsidered over time. This will allow for the possibility of changing the scope, including the level of audit reassurance, to reflect factors such as transitional requirements, changes in requirements, and past experience as to the level of auditing required for specific information. Should the earlier years provide significant

<sup>101</sup> Telecom Draft Notification Submissions, page 19.

<sup>102</sup> <http://www.annualreport.telecom.co.nz/2008/download/telecom-annual-report-2008.pdf>, page 63.

<sup>103</sup> Telecom Draft Notification Submissions, para. 70.

<sup>104</sup> *Ibid*, para. 76.

<sup>105</sup> *Ibid*, para. 77.

<sup>106</sup> PwC, *Review of Costs to Implement Accounting Separation and Regulatory Reporting Requirements*, 9 December 2008, page 9.

assurance of the robustness of the regulatory reporting processes, the audit requirements may be relaxed in later years.

303. The Commission's view is that having the regulatory financial statements audited to a high level of assurance will provide a high level of reassurance to the wide audience. However, the Commission is also aware of the costs such a level of assurance can incur, particularly when applied at a disaggregated level. Therefore, the Commission considers that reducing some of the requirements proposed in the Draft Notification would be appropriate for the financial years ending 2009 and 2010. These modifications include:
- preparing audit opinions in accordance with the "prepared, in all material respects, in accordance with" standard rather than the more stringent "fairly presents" standard; and
  - eliminating the requirement that the independent auditor provide separate audit opinions on the manuals.
304. The Commission considers that the compliance monitoring information to be provided to the Commission will provide a means by which the Commission can evaluate Telecom's compliance with the requirements.

#### *Commission Decision*

305. The Commission considers that Telecom should be required to engage an independent auditor. The regulatory auditor must not be involved in the preparation of or have given advice on the preparation of the regulatory reports and/or compliance monitoring information. Telecom may engage the same auditor to audit both the information disclosed for these regulatory purposes and for statutory reporting purposes, provided the relevant professional standards allow this whilst ensuring audit independence.
306. For the reporting years ending 30 June 2009 and 30 June 2010, Telecom is required to engage an independent regulatory auditor to form an audit opinion to the "presented in all material respects in accordance with" standard for the Regulatory Financial Statements and, for the 2009/2010 financial year, the product statements. These requirements are contained in clause 16 of the Requirements.

#### **Materiality**

##### *Commission View*

307. The Commission considers that the materiality of the audit review is an important consideration for the public perception of the reliability of the published financial statements. At the same time, an overly low or inflexible view of materiality can have substantial impact on the cost of the audit, and therefore might not be reasonable. A high materiality threshold, on the other hand, would decrease the value and reliability of the published information.
308. The choice of an appropriate materiality metric is influenced by the nature of the information being reported on. There is therefore a degree of uncertainty as to the most appropriate materiality metric. Until information has been disclosed, therefore, the Commission considers that it should set materiality requirements for the 2009 financial year only. After the expiration of the 2009 financial year, the Commission may issue more focused materiality requirements following its review of the information disclosure regime.
309. The Commission has the preliminary view that the audit of the products statements should have a materiality level of 1% of revenue, however as the products statements

are not required until 2010, this preliminary view is not included in the Requirements. The initial materiality levels, below are comparable to those used for statutory audit of listed corporations, while also reflecting that the regulatory audit is a special purpose audit. The Commission considers that higher levels of materiality would lead to an excessive error margin, and would undermine the reliability of the information. Therefore the Commission considers that the initial materiality levels, below, are appropriate and reasonable.

*Commission Decision*

310. The Commission has adopted materiality requirements for the initial reporting year in clause 16 of the Requirements. These requirements are summarised in the table below.

<b>Statement</b>	<b>Consolidated</b>	<b>Service Group</b>	<b>Product</b>
Regulatory Statement of Financial Performance	1% of revenue	1% of revenue	N/A
Regulatory Statement of Mean Capital Employed	1% of total assets	1% of total assets	N/A
Regulatory Statement of Fixed Assets	N/A	1% of total fixed assets	N/A
Regulatory Statement of Asset Movement	N/A	1% of net movement of all assets	N/A

## 10. IMPLEMENTATION

311. The Act does not specify when regulatory accounting should commence, subject to section 69ZB(3) which states that the information disclosure requirements must be finalised after the separation plan has been approved. The separation plan was finalised in early 2008. The Act allows for the use of transitional processes during the implementation period.
312. In the Draft Principles Paper the Commission proposed that:
- ...full regulatory reporting will commence on 1 July 2009, with limited transitional provisions applying for the year 1 July 2008 to 30 June 2009.
313. The Draft Notification also proposed that the financial year ending 30 June 2009 would be a transitional year and that year ending 30 June 2010 would have full regulatory reporting.
314. Both draft papers sought submissions on the timing of Telecom's 2008/09 and 2009/10 information disclosure requirements, with the Draft Notification including a timeline. This timeline included a series of milestones during the transitional year with the first years' regulatory financial statements due 31 December 2009. For the following year, regulatory reports were due by 1 December 2010.

### *Submissions*

315. All submissions either supported or did not challenge the view that Telecom should prepare some form of regulatory accounts for the 2008/09. The submissions differed over whether 2008/09 should be a transitional year, and what that meant in terms of timing and any other transitional arrangements.
316. In response to the Draft Principles Paper, Telecom proposed that the methodologies and reporting formats be agreed by 30 June 2009, and the first reports be provided by 30 June 2010. Product statements would not be produced for 2008/09, but would be provided in March 2011 along with the other regulatory reports for 2009/10.<sup>107</sup> Telecom argued that 2008/09 should be a transitional year and that the implementation workload justifies taking 12 months to prepare the first set of regulatory accounts and deferring the product statements and audit for a year.<sup>108</sup>
317. In response to the Draft Notification, Telecom maintained its view for a transitional year, and proposed its own series of milestones. Telecom submitted that it could not achieve the timeline proposed by the Commission due to factors such as resource constraints and minimum required timeframes.<sup>109</sup> Telecom proposed that for the transitional year the regulatory financial statements should be due on 31 December if the audit requirements were reduced ("prepared in accordance with") or delayed two months until 27 February if a higher level of audit assurance were required ("fairly presents"). For 2009/10 Telecom proposed a publication date of 31 December 2010 (with a "fairly presents" level of assurance).
318. NZ Communications submitted in favour of a short implementation timeline.<sup>110</sup>
319. InternetNZ submitted against a transitional year. InternetNZ argued that the implementation period is much longer than it needs to be, and that the nearly four year

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<sup>107</sup> Telecom Draft Principles Submission, pages 28-29.

<sup>108</sup> *Ibid*, pages 4-5.

<sup>109</sup> Telecom Draft Notification Submission, page 5.

<sup>110</sup> NZ Communications, *Submission to the Commission*, 18 July 2008.

delay (from the passing of the Act) in getting the first full report is unnecessary. InternetNZ considered that product statements should be prepared in 2008/09.<sup>111</sup>

320. InternetNZ considered that the existing body of material on regulatory accounts would allow for an expedited implementation of these regulatory accounting requirements.<sup>112</sup>

The Commission and Telecom already have available to them a wealth of information as to how to structure the disclosure requirements, including the BT experience before and after operational separation (as to which there is extensive documentation), the ERG guidelines and the extensive body of material developed since 2001 in relation to the electricity sector.

More importantly, Telecom has been producing the great majority of the required information for a considerable period (including as to Chorus and Wholesale for some months before Separation Day).

The accounts can be prepared retrospectively. They do not need to be provided until three months after the end of each financial year and so Telecom can move to full accounts for the current financial year. The transitional year is not required.

321. In its cross-submission InternetNZ argued that the reasons cited by Telecom did not justify an extended timeline. InternetNZ proposed that Telecom should prepare its regulatory accounts within three months of balance date (30 June) starting from 2008/09. InternetNZ compared the timeframe with that on BT, which must prepare regulatory audited reports within four months of balance date.<sup>113</sup>

322. InternetNZ did not specifically comment on the milestones proposed in the Draft Notification. In response to the Draft Notification, InternetNZ commented on the need to regularly review the requirements.<sup>114</sup>

Appropriate disclosure will evolve over time, reflecting both technology and commercial change, and also the need to develop the regime based on experience. While the Commission can review the approach at any time, we suggest that, for the first three years, provision for an annual review, with consultation, is included in the Requirements document. That is consistent with Ofcom's approach, for example.

#### *Commission View*

323. The Commission considers that it is important to have information disclosure for the 2008/09 financial year. Current developments in the telecommunications industry, such as the introduction of the Standard Terms Determinations process through the Telecommunications Amendment Act 2006, the implementation of operational separation, and investment in broadband technologies, provide an environment in which the publishing of information relating to 2008/09 will be of great value to the industry, policymakers, regulators, and end-users.

324. The Commission agrees in principle with Telecom's assertion that the introduction of regulatory accounting presents challenges which justify a transitional period, and with InternetNZ's statement that existing material, such as that from Ofcom and BT, will help Telecom implement regulatory accounting quickly. The Commission considers that reduced requirements in the first year are appropriate, but that the availability of

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<sup>111</sup> InternetNZ, *Submission to the Commerce Commission on the Draft Principles and Reporting Requirements for the Accounting Separation of Telecom*, 21 July 2008, para 13.7.

<sup>112</sup> *Ibid*, para 13.3.

<sup>113</sup> InternetNZ, *Further Submission to the Commerce Commission on Draft Principles and Regulatory Reporting Requirements for the Accounting separation of Telecom* 15 August 2008, para 17.3.

<sup>114</sup> InternetNZ, *Submission to the Commerce Commission on Draft Notification of Information Disclosure Requirements*, 7 November 2008, page 2.

overseas precedent should reduce (but not eliminate) the effort required to implement full information disclosure.

325. The Commission considers that a disclosure date of 31 December 2009 for the transitional set of regulatory reports is appropriate.
326. The Commission considers that for the 2008/09 reporting to provide a thorough testing of the regulatory accounting process, it should include elements of most key components of the framework. Such experience will allow the lessons to be incorporated into the requirements for 2009/10, and will help ensure that the process is working fully for 2009/10. Therefore, the first year should include elements of the full regulatory reporting regime, as well as compliance monitoring and auditing requirements. However, the first year should not include a requirement to produce product statements, which should reduce the effort and time required by Telecom to implement the requirements.
327. The Commission considers that the regulatory reports for 2009/10 should be published by 1 December 2010. This will give Telecom five months from the balance date to complete the reports, and will help to ensure the information is timely. This timing is comparable to the Commission's requirements in the electricity sector, where regulatory reports are completed within five months, and is longer than Ofcom's requirements in the UK where BT has four months. It is also longer than the period within which Telecom prepares its annual reports; the full year results for 2008 were announced on 8 August 2008<sup>115</sup> and the audit opinion was dated 21 August 2008.
328. In selecting the above dates the Commission has considered the reduced reporting and audit requirements for the first year and Telecom's existing systems capabilities. Relevant factors include Telecom's progress-to-date in implementing necessary management accounting systems and processes, updates to the asset registers, and trading arrangements needed for operational separation, as well as the completion of a statement of fixed assets controlled by Chorus as of 1 July 2007. The Commission considers that this capability should place Telecom in a position to prepare regulatory accounts within the above timeframes.

#### *Commission Decision*

329. The Commission considers that Telecom should be required to prepare and disclose information starting with the financial year ending 30 June 2009, with a publication date of 31 December 2009.
330. Telecom will be required to publish the information required for the financial year ending 30 June 2010 by 1 December 2010.

## **Review of Requirements**

#### *Commission View*

331. As stated earlier, the Commission anticipates that the information disclosure requirements will be reviewed over time. This review will allow experience and changing audience requirements to be incorporated into future information disclosure obligations under section 69ZB.

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<sup>115</sup> <http://investor.telecom.co.nz/phoenix.zhtml?c=91956&p=irol-calendarPast>, as of 12 February 2009.

332. The Commission considers that consultation would be desirable during such a review, and considers that one benefit of such consultation will be identifying how the information publicly disclosed meets the audience's needs. The Commission considers that such consultation should occur on a regular basis.
333. Section 69ZD(1)(j) authorises the Commission to:
- (j) make requirements from time to time (for example, more than once a year)
334. The Commission will actively monitor the implementation and development of the information disclosure requirements. Particularly during the first year, Telecom will have considerable control over the implementation of the principles and the reporting requirements. While the Commission may monitor Telecom's implementation of the Requirements using its compliance monitoring authority,<sup>116</sup> the Commission considers that there may be a need to take clarify or amend its decisions where:
- Telecom is incorrectly or improperly implementing the requirements;
  - the manuals and/or methodologies used by Telecom in preparing and disclosing the information are inconsistent with the Commission's decisions;
  - the process of implementation of the requirements may decrease the reliability or utility of the information to a wide audience.
335. In such circumstances, the Commission considers that it may need to issue additional requirements, or modify the existing requirements, to best given effect to the purpose.

#### *Commission Decision*

336. The Commission expects to review the requirements following the publication of its summary and analysis of information disclosed for the Telecom financial year ending 2009.

### **Confidentiality and Exemptions Process**

337. In considering the reasonableness of the Requirements, the Commission must take into account the confidentiality of the information to be disclosed. The Commission has considered the confidentiality of the information in reaching its decision on the final Requirements.
338. Section 69ZD(1)(h) authorises the Commission to provide exemptions from information disclosure requirements.
339. In the Draft Principles Paper, the Commission expressed the view that the Requirements should provide a means of ensuring the appropriate protection of confidential information. The Commission proposed that it should consider confidentiality in a manner similar to the confidentiality order regime. The Commission did not present any preliminary views on an exemptions process.

#### *Submissions*

340. The Commission received no substantive submissions on the form or nature of a confidentiality provision, or on an exemptions process.

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<sup>116</sup> Section 69ZF(1)(b).

*Commission View and Decision*

341. The Commission considers that a confidentiality provision will provide additional assurance that the information to be disclosed by Telecom is reasonable.
342. The Commission has included a confidentiality request provision in clause 14.3 of the Requirements, and an exemptions process in clause 15.