



**Further Submission to the Commerce Commission on
Draft Principles and Regulatory Reporting Requirements
for the Accounting Separation of Telecom**

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Public Version
(there is no confidential version)

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1 Executive Summary

1.1 Telecom has fundamentally misunderstood the information disclosure requirements, from a policy and outcome perspective, and in the way that it interprets the Act. This has led Telecom into serious error in its approach. For example, contrary to Telecom's submissions, information disclosure requirements are not limited to the ambit of operational separation (and the disclosure obligations are not limited to short-form low-detail statements at product and business unit level).

1.2 The outcome is that Telecom proposes largely meaningless reports. That proposed outcome is enough in itself to justify the Commission imposing prescriptive and detailed requirements upon Telecom, given the incentives, identified by the Commission, for incumbents to prepare reports using methodologies favourable to their position.

- 1.3 As there is such a wide gulf between what Telecom proposes, and the approach by the Commission and InternetNZ (as well as the approach in the UK), we respond to the Telecom submissions in some detail.
- 1.4 Telecom correctly notes that we are unique in regulating accounting separation after operational separation and the Commission has a fresh opportunity to consider the best structure. However, Telecom, curiously, does not take the obvious step of addressing what BT and Ofcom did to its information disclosure regime after the introduction of the BT operational separation. Telecom's operational separation is modelled on theirs and the policy approach to information disclosure is similar too (if anything, the UK disclosure regime is more restricted). The UK would seem to be the best source of guidance for the Commission as to what to do about information disclosure following operational separation.
- 1.5 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. We give two up-to-date (2008) examples of this.
- 1.6 Strong grounds should be demonstrated, to justify deviation from the UK approach post-operational separation. They have not been demonstrated.
- 1.7 By contrast to the handful of pages that Telecom proposes, BT's latest regulatory reporting, including underlying reports, cover several hundred pages. Even the BT reports at the level of Telecom's proposed reports (the Current Cost Financial Statements for 2007 including Openreach Undertakings), which consolidate underlying information, are far more extensive in number and in detail.
- 1.8 The continued need for robust regulatory financial reporting post-operational separation is not surprising, based on views expressed by the "father" of the ladder of investment, Professor Cave, in June 2008. He considers that operational separation is a tool to deal with non-price discrimination rather than price discrimination (for which other tools are more suitable). On the basis of his view, disclosure of price/financial material remains just as necessary post-operational separation.
- 1.9 Contrary to Telecom's submission, reports and monitoring (such as by the Independent Oversight Group) under the Undertakings do not diminish the need for information disclosure under Part 2B of the Act

- 1.10 We address the policy, principles and objectives behind accounting separation, by reference to the New Zealand legislation and guidance from the European Regulators Group.
- 1.11 The legislation provides a broad palette, to enable the Commission to fulfil the wide Section 69Y objectives, including transparency and promotion of competition in the long term interests of end-users.
- 1.12 We conclude that granular and comprehensive reporting is required on policy grounds, and that this extends to business units and services other than those which are the immediate focus of accounting separation (that is because a full picture of the business is required to have adequate disclosure).
- 1.13 InternetNZ is particularly concerned at Telecom's resistance to disclosure of statements of capital investments (in particular, major investment such as the NGN).
- 1.14 One facet of this is the need for access seekers and other stakeholders to have adequate information to be able to adequately participate in consultation. The structure around Telecom's consultation process, under its undertaking commitments is uncertain, inadequately documented, and weak, compared to BT's, particularly after changes agreed this year between Ofcom and BT.
- 1.15 As adequate consultation requires access seekers to have adequate information, and it appears that Telecom does not intend to adequately disclose, it is appropriate (and within the Act's objectives) to require sufficient information disclosure to enable adequate consultation, as required by the Undertakings.
- 1.16 Telecom is suggesting delays in providing reports well beyond the Commission's proposals (which in our view were too generous anyway). The first reports would not be available for 3 ½ years after the Act was passed. This can and should be expedited. There is ample international precedent, and other material, to have the historical reports available for the current financial year, by October 2009.

2 Telecom's fundamental misunderstandings

- 2.1 From the outset of its submission, Telecom has misunderstood the information disclosure requirements, from a policy and outcome perspective, and in the way that it interprets the Act. This has led Telecom into serious error in its approach.

2.2 The outcome is that it proposes largely meaningless reports, centring around high-level short-form accounts.

2.3 These misunderstandings, and the consequent proposals for minimal reporting, are factors that the Commission can and should take into account to expand the reporting obligations upon Telecom. They demonstrate:

2.3.1 the reality of a risk identified by the Commission in its draft Guidelines: the incumbent does its reporting by methodologies and interpretations that are unduly favourable to it;

2.3.2 that more detailed reporting, and a more prescriptive approach, is required. For example, careful methodologies for calculating and reporting transfer pricing and cost/revenue allocation is required.

3 First misunderstanding

3.1 The misunderstandings start at the beginning of the submissions, with a key error of approach¹ which affects the rest of the Telecom approach. Telecom records its understanding of the purpose of information disclosure, as stated in Section 69Y. The purpose as stated in Section 69Y is said by Telecom to be based on the operation and behaviour of:

Telecom's operationally separated business activities

3.2 Section 69Y does not state this. Instead it states that the purpose is about the operation and behaviour of:

Telecom's network, wholesale, and retail business activities and services

3.3 This clearly is not just "operationally separated business activities". This disclosure regime is not just about operational separation. If the disclosure requirements were to be so limited, the Act would have said so. It does not. The Information Disclosure regime was in the Bill, largely in the same form, before operational separation was added. No change was made to the Bill after operational separation was added, to limit the scope of information disclosure². This further confirms the breadth of the disclosure requirements.

3.4 In any event, our initial submissions set out reasons why the range of potential information disclosure obligations is wide.

¹ Telecom submissions; Para 10

² See the Select Committee report and Bill at http://www.parliament.nz/NR/rdonlyres/9880C157-E3E2-413C-9DC1-EB2A98B8BE5E/48382/DBSCH_SCR_3592_4054.pdf

4 Granularity of the reporting requirements

- 4.1 Telecom, continuing a similar theme, appears to submit that disclosure obligations as to business activities are, under the Act, only at the level of the operationally separated units (Chorus, Wholesale, and Retail)³. So, for example, Telecom proposes that accounts for Wholesale should not be provided with greater granularity than the full operationally separated Wholesale unit.
- 4.2 This cannot be correct, quite apart from the express and overlooked right for the Commission to require separate information about all **or part of** business activities or services, within the network, wholesale or retail categories⁴. The Commission can choose a level of granularity much more detailed than at the level of operationally separated business units. It should do so, where that helps achieve the purpose of Part 2B.
- 4.3 As Telecom is proposing far less disclosure than is proposed by the Commission and InternetNZ, we return below to reasons why a much higher level of granularity is required.

5 Does operational separation reduce the need for accounting separation?

- 5.1 Telecom argues that the extent of regulatory reporting should markedly diminish due to operational separation. It notes that we are unique in regulating accounting separation after operational separation, and we can avoid the unnecessary complexity of overseas models, without compromising the objectives of the Act. Telecom maintains that a number of regulatory objectives – including preventing cross-subsidies – are dealt with comprehensively by operational separation⁵, and there are already significant reports required⁶.

- 5.2 As noted in our earlier submissions, accounting separation:

- 5.2.1 extends beyond price/financial issues arising under operational separation (therefore, there is a requirement for information disclosure broader than the ambit of operational separation);

³ Telecom submissions: Para 12 to 16

⁴ Telecommunications Act Section 69ZB(2). "Prescribed" in this context means as prescribed (chosen) by the Commission: Section 69ZA

⁵ Telecom submission; Page 3

⁶ Telecom submission; Para 25

- 5.2.2 extends to reporting on non-price issues (this occurs, for example, in Australia under their Record Keeping Rules regime, which has a narrower ambit than New Zealand's Part 2B⁷).
- 5.3 Our submissions on those and other issues in our earlier submission are unchanged.
- 5.4 However, even assuming Telecom is right in limiting information disclosure to financial issues within the ambit of operational separation, Telecom's conclusion is not correct. We now deal with the position based on Telecom's assumption.
- 5.5 We agree with Telecom's aim of avoiding unnecessary complexity, without compromising the objectives of accounting separation. The Commission should be alive to the opportunities to achieve this. We doubt however that operational separation will materially reduce appropriate information disclosure.
- 5.6 Telecom correctly notes that we are unique in regulating accounting separation after operational separation and the Commission has a fresh opportunity to consider the best structure. However, Telecom, curiously, does not take the obvious step of addressing what BT and Ofcom did to its information disclosure regime after the introduction of the BT operational separation. This would seem to be the best source of guidance for the Commission as to what to do about information disclosure following operational separation.
- 5.7 Rather than reducing the disclosure obligations, Ofcom has generally confirmed them and, in some instances, added additional reporting obligations.
- 5.8 Our operational separation model is based on the UK's operational separation. The regulatory reporting regimes overlap in terms of objectives and reporting options. New Zealand's Part 2B regime is considerably wider than the potential ambit of the UK regime.⁸ Therefore, the UK experience provides a robust benchmark of the minimum approach for New Zealand when deciding on the extent of disclosure in light of operational separation.
- 5.9 Strong grounds should be demonstrated, to justify deviation from the UK approach post-operational separation. They have not been demonstrated.
- 5.10 We addressed the changes to the regulatory financial reporting requirements, as between Ofcom and BT, in our original submissions. As there is a large chasm between what Ofcom has done post-operational

⁷ Section 151BU Trade Practices Act 2004 (Aust). See also the description of non-price regulatory reporting in Professor Cave's paper noted below).

⁸ The New Zealand Part 2B regime appears to be significantly wider. For example, it is not necessary here to demonstrate SMP (or some New Zealand variation of this) before imposing reporting obligations. See Ofcom's 2006 statement, Changes to BT's regulatory financial reporting and audit, at Para 2.9-2.11.

separation in the UK, and Telecom's proposed minimalist approach (which is said to be based on operational separation), we go into more detail as to what changes were made in the UK after operational separation commenced.

6 How did Ofcom change information disclosure requirements after the BT Undertakings?

6.1 Ofcom reviews and changes BT's regulatory financial reporting obligations frequently, to reflect changes. This typically happens annually. 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.

6.2 In 2006, Ofcom issued its first relevant regulatory Statement post-operational separation: *Changes to BTs regulatory financial reporting and audit*. In the Statement, and in the knowledge that the Undertakings were in place, Ofcom noted why regulatory financial reporting is needed:

The need for regulatory financial reporting information

2.5 Regulatory financial information is fundamental to the economic regulation of the electronic communications sector and in particular to many of the decisions of Ofcom.

2.6 The need for regulatory financial reporting information was discussed in detail in paragraphs 2.22 to 2.26 of the July 2004 Statement and, in summary, is used mainly to:

- demonstrate compliance with cost-orientation and non-discrimination obligations;*
- support investigations into potential breaches of conditions or potential anticompetitive practices;*
- set and monitor price controls and;*
- inform policy setting and market reviews.*

2.7 However it is important to stress that such financial information needs to be provided in a timely manner, be of high quality, prepared to high standards and be relevant to the task at hand.

2.8 In addition, certain modifications to current obligations (such as the revision of the Network Component List [a key element in the equivalent of the Commission's proposed product statements]) will improve the quality and transparency available to Ofcom, the industry and stakeholders.

6.3 Ofcom made minimal diluting changes to BT's regulatory financial reporting obligations at this point. Thereafter, Ofcom continues actively to adopt and develop the regulatory financial reporting regime, to meet changing needs and developments. Two 2008 examples illustrate how operational separation has not reduced BT's information disclosure obligations:

First Example: Ofcom's 2008 review of regulatory financial reporting.

In its June 2008 Statement, *Changes to BT's 2007/08 regulatory financial statements*⁹, Ofcom has introduced, among other things, additional transfer charge reporting requirements, and additional reporting requirements as to the network components for BT's NGN build (the 21CN network)¹⁰

"Network components" is the term used by Ofcom to describe the various assets and activities used in provision of services for which regulatory reporting is required¹¹. Network component reporting enables, among other things, appropriate cost attribution and transparency.

Thus, when Ofcom deals with "network components" there is a direct overlap with the Commission's proposed product statements.

The 2008 Statement and Consultation are useful as they highlight Ofcom's approach, which should apply here too. Ofcom's required reporting regime evolves to reflect developments. To illustrate the position we will deal with the approach in the Statement at a broad level. Then we will deal with how the Statement approaches the specific issue of NGN/21CN reporting.

First, at a broader level, Ofcom notes, in its 2008 Statement, its overall approach as follows¹²:

The current regulatory financial reporting regime for British Telecommunications plc (BT) has evolved over time in response to ongoing changes in the regulatory, technological and competitive environment, including:

- ***changes in the regulatory framework (following Ofcom's strategic review of the telecommunications sector);***
- ***structural changes in the way BT transacts with itself and its competitors (by way of the ongoing implementation of undertakings by BT accepted by Ofcom in lieu of a reference under the Enterprise Act and the creation of Openreach);***
- ***technological changes to the nature of BT's business, including the move to the next generation network, which BT refer to as their 21st Century Network (21CN);***
- ***changes in the way financial information will be made available to Ofcom (via the implementation of a new data extraction tool); and***
- ***the results of various regulatory decisions including market reviews and investigations. [highlighting added]***

This is typical of the approach taken by Ofcom after the commencement of operational separation, referring as it does specifically to the changes in the regulatory framework following Ofcom's strategic review (which led to operational separation) and the operational separation itself. Having taken into account those issues, Ofcom has not significantly diluted BT's reporting obligations in view of operational separation, either in this Statement or previously.

The Statement further notes:

1.4 This [regulatory financial reporting] information can be either on a regular (e.g. annual)

⁹ The relevant documents are at <http://www.ofcom.org.uk/consult/condocs/btregs08/>

¹⁰ See the Executive Summary and Section 2 of the Statement

¹¹ See the Consultation document at Para 4.1 (<http://www.ofcom.org.uk/consult/condocs/btregs08/>)

¹² June 2008 Statement, *Changes to BT's 2007/08 regulatory financial statements* Para 1.3

basis for ongoing monitoring purposes or on-request, for example in connection with investigations.

2.5 Regulatory financial statements, like any form of business information, evolve over time to reflect a range of internally and externally driven factors. These include changes to accounting policies and standards, improved understanding or knowledge of cost drivers, changes in technologies and business processes and changes in the regulatory environment.

As in the UK, the NZ information disclosure regime also involves, as specifically provided for in the Act¹³, ongoing review and updating.

Moving to an example at the detail level, we turn now to the way in which Ofcom has handled the more granular issue of reporting on C21/NGN network components. This is illustrative of how information disclosure requirements evolve over time, to reflect key changes, when there is the added issue of uncertainties.

The example is particularly relevant to NZ as it deals with NGN, which has been highlighted by the Commission as a key area for information disclosure.

Ofcom, in its 2008 Statement, notes that, faced with NGN uncertainties:

4.4 BT's investment in a new core network is significant and from a regulatory aspect clear and transparent accounting for these costs is important.

4.5 Ofcom recognises that a full understanding of the way in which this new network will operate, what drives the costs and any impact on regulated services, is still in the very early stages of development. We therefore believe that, at this time, disclosure of the main parts of the new network is important for transparency purposes and stakeholder understanding.

4.6 This is the first stage of incorporating 21CN into BT's regulatory financial statements. This will give transparency to the costs and where they are being attributed so that we can formulate an effective reporting regime as the new network comes into use.

4.7 We will review with BT the appropriateness of their cost attributions. As the cost data becomes more robust and our understanding improves we will be analysing the information and implementing changes to BT's costing methodology if necessary. [highlighting added]

This approach by Ofcom shows, in a way that is illustrative for New Zealand, that there should be reporting to reflect new developments such as the NGN, but that this can develop and become more granular over time. The Commission is able to take a similar approach, and can prioritise its focus in the initial period. This however should not allow excessive delays, particularly for the reasons identified in our earlier submissions.

Second example: Openreach's 2008 request to increase its LLU and other pricing.

Ofcom has indicated it may allow increase of this pricing in view of cost increases faced by Openreach¹⁴. LLU is at the heart of both the UK and NZ operational separation models. In its May 2008 consultation document, A New

¹³ Section 69ZD(1)(j)

¹⁴ It is consulting on pricing of WLR, MPF and SMPF. MPF and SMPF are components in LLU: see Para 1.2 of the document referred to in the following footnote.

Pricing Framework for Openreach, Ofcom confirms that the consultation will use and rely upon the current cost statements produced as part of the regulatory financial reports¹⁵.

7 The extent of BT's regulatory reporting, compared to Telecom's proposal

- 7.1 It appears that Telecom intends only to provide short financial statements, without underlying detail. Those statements will, in themselves, be at a low level of granularity. For example, Wholesale reports will be for the whole division and not broken down into relevant parts.
- 7.2 By contrast to the handful of pages that Telecom proposes, BT's latest regulatory reporting, including underlying reports, cover several hundred pages¹⁶. Even the BT reports at the level of Telecom's proposed reports (the *Current Cost Financial Statements for 2007 including Openreach Undertakings*), which consolidate underlying information, are far more extensive in number and in detail.
- 7.3 Telecom has not demonstrated why there should be a departure from the level of granularity in the Ofcom approach, which reflects carefully worked through requirements over the years. That includes reviews by Ofcom in 2006, 2007 and 2008, taking into account implementation of operational separation.
- 7.4 Additionally, Ofcom has taken into account the cost of preparation of the accounts compared to the benefits. Like New Zealand, Ofcom has an obligation to consider proportionality and a cost/benefit consideration of the level of detail of reporting.

8 Professor Martin Cave's view

- 8.1 The continued need for robust regulatory financial reporting post-operational separation is not surprising, based on the views expressed by Professor Cave in his June 2008 paper on Australian National Broadband Network regulatory issues, *Vertical Integration and the Construction of NGA Networks*¹⁷.

¹⁵ <http://www.ofcom.org.uk/consult/condocs/btregs08/> Paras 4.12 to 4.18

¹⁶ See the accounts and underlying reports at <http://www.btplc.com/Thegroup/Regulatoryinformation/Financialstatements/2007/Regulatoryfinancialstatements2007.htm>

¹⁷ http://www.dbcde.gov.au/communications_for_business/funding_programs_and_support/request_for_submissions_on_regulatory_issues/submissions/Martin_Cave.pdf

- 8.2 He considers that operational separation is a tool to deal with non-price discrimination rather than price discrimination (for which other tools are more suitable):

If the incumbent can offer better terms to itself than to its competitors in downstream markets, it can exclude them from or weaken them in those markets.

*Such discrimination can take two forms: price and non-price. I am aware of arguments made in Australia, by the ACCC Chairman among others, that stronger separation of Telstra would address the perceived shortcomings in the current accounting separation model: in other words, separation is seen as a sharper tool in achieving non-discriminatory pricing than accounting separation. **However, in Europe, functional and operational separation are clearly understood as a remedy for non-price discrimination. Regulators have available other tools with which to address issues such as price squeezes. This was very much the basis on which Ofcom proceeded in requiring functional separation of BT.**¹⁸*

...If..... the real issue of dispute between Telstra and its competitors is price discrimination, then for the reasons I have discussed above, operational or functional separation is unlikely to be the right tool to address it.¹⁹ [highlighting added]

- 8.3 Our operational separation of course is based on the UK approach. Thus, while both models can address price to some extent (for example, the EOI definition in both countries encapsulates price), Professor Cave is saying that the real focus of operational separation is non-price discrimination.
- 8.4 On the basis of Professor Cave's view, other tools such as accounting separation remain important and should not be diluted by reason of operational separation: he considers operational separation is not aimed at price/financial issues.

9 Do Telecom's operational separation reporting commitments dilute the need for accounting separation?

- 9.1 To justify reduced information disclosure under the Act, Telecom refers to reports it must provide to the Independent Oversight Group (IOG) and to the Commission (and the monitoring by each)²⁰.
- 9.2 We do not agree that this reporting and monitoring is adequate to deal with financial issues such as cross-subsidies and discrimination. This is so even based on Telecom's submission that reporting under Part 2B applies only to issues arising under operational separation. However that is not the case, as noted above.

¹⁸ Martin Cave at Page 11

¹⁹ Martin Cave at Page 14

²⁰ Telecom Submission; Para 25-30

9.3 However even where operational separation and the prospect of accounting separation intersect, the need for disclosure is not reduced by the reporting and monitoring roles of the IOG and the Commission under the Undertakings.

9.4 Further, detailed information disclosure is essential to enable the Commission and the IOG to undertake their monitoring. This includes, for the Commission, its monitoring beyond the ambit of operational separation. We illustrate this by working through Telecom's first reason why information disclosure under Part 2B should be minimal.²¹

Transfer Charge reporting to the IOG

Telecom maintains that merely documenting internal trading arrangements including transfer charges, with that documentation copied to the IOG, is enough²²

Clause 57.2 of the Telecom undertakings is typical of the limited points where the Undertakings require this type of approach. For particular (not all) services supplied by Wholesale to Retail, the arrangement must be documented, setting out "*the terms of supply, including price or appropriate transfer charges*".

Without more than that, the IOG cannot assess whether the transfer charges are correctly and rationally set, whether the effect is to cause discrimination and cross-subsidy, etc. As the Commission notes, Telecom has incentives to favour its own position, by the way it selects the methodology for transfer charges.

That Telecom regards this low-level disclosure to the IOG as adequate is of concern.

The IOG can ask for more information under the operational separation undertaking. However, to be able to do monitoring of financial issues such as transfer charges, properly, if it chooses to do so:

- it would have to ask for the thick end, or all, of what robust information disclosure under the Act would achieve anyway;
- it would be better for the IOG to use comprehensive information provided to it via the Part 2B information disclosure regime;
- The IOG is not well suited to get information of this level of detail. It does not have the resources, and the IOG, which includes Telecom employees (and Telecom employed-staff) is not well set up to do this detailed work;
- By contrast, the Commission has strong expertise in this area, and that expertise extends beyond the telecommunications sector. The disclosed information can be made available to the IOG (confidentially where that

²¹ Telecom Submission; Para 27

²² Telecom Submission; Para 27

is appropriate);

- The IOG would need to seek information disclosure on a consistent and comprehensive basis. Missing out on particular components of available information renders the analysis inadequate. In that regard, we note that it is only certain transactions that need to be documented and reported to the IOG under the Undertakings. Yet adequate information disclosure requires more comprehensive reporting, as we note below.

It is particularly significant that the information should be obtained anyway and made available to a wider audience (which includes the IOG itself). The IOG would get it –almost invariably – confidentially.

As we noted in our earlier submissions, it is important for the industry and other stakeholders to be able to assess this information as well, subject to confidentiality constraints. The Commission should have the ability to get and use the information.

Industry and the Commission have additional remedies not available to the IOG, such as pursuit of price squeeze and predatory pricing allegations under competition law. If the information goes only to the IOG, all this will be lost.

For example, establishing that there is EOI in relation to price does not in itself eliminate concerns as to price. The wholesale service (with a regulated price) could be supplied on an EOI basis, yet the relativity between Telecom retail's price in the retail market, and the wholesale price, could be such that there is a price squeeze.

The need for transparency and granularity is well illustrated by MED's request for careful disclosure in relation to TSO. InternetNZ supports the general approach in those submissions, which also illustrate that:

- information disclosure is not limited to the ambit and structure of operational separation;
- there is a wide variety of areas for which information disclosure is appropriate, beyond the immediate and strict confines of regulated services and operational separation. Part 2B provides a wide array of information to be disclosed, to meet the broadly stated purposes in Section 69Y.

In summary, a rational approach to price issues such as cost allocation and transfer charging is critical to achieving both price and non-price equivalence. Without adequate disclosure under Part 2B, this will not be achieved. Further, there are issues beyond price equivalence and the Undertakings, which are relevant such as competition law issues. Accounting separation is an essential complement to operational separation. Reporting obligations (and monitoring by the IOG) under the Undertakings is not sufficient.

10 The principles and objectives of information disclosure

10.1 The principles and objectives in New Zealand are clear enough, reflected also in the overseas approaches. However, as Telecom seeks such limited, and largely ineffectual, disclosure, compared to that proposed by the Commission and InternetNZ, it is helpful to further address underlying principles and objectives.

10.2 They are clear from Part 2B itself. The list of information which can be required to be disclosed is very wide. It is wider than any other information disclosure regime that we have seen including the regimes in Europe and Australia (although the Australian regime comes close). Of course, required disclosure will be confined to what is needed to meet the Section 69Y purpose statement, but that is also widely cast.

10.3 In summary, the Act provides a broad palette, to enable the Commission to fulfil the Section 69Y objectives, including transparency and promotion of competition in the long term interests of end-users.

10.4 Guidance from overseas is useful, as other countries are dealing with largely the same underlying issues. We have already referred to the UK as an example. The Accounting Separation Guidelines prepared by the European Regulators Group (ERG) are particularly helpful. European regulation, covered by those guidelines, is more limited than Part 2B. Therefore, the ERG Guidelines are a minimum for NZ and do not include, for example, non-price reporting, which is available in NZ and Australia. The differences between New Zealand and Europe include a specific limit to reporting related to services where SMP has been established. There is no such limit in New Zealand. However, as we develop below, even where the focus is the SMP product, reporting for non-SMP businesses and services is generally required.

10.5 While reporting in New Zealand will often focus around products where there is the equivalent of SMP, that is not an essential requirement. For example, where the Commission has concerns that there is the possibility of adverse impact on competition, it can gather information to assess the position with a view to taking action later. That is an approach used by ACCC for example in relation to information disclosure in respect of roaming²³ and Internet peering (we deal with peering separately below).

10.6 We will now deal with particular facets of the principles and objectives, relying in particular on the ERG Guidelines as guidance for New Zealand.

11 Transfer pricing

11.1 The ERG guidelines deal with the major area of transfer charges as follows:

A well-defined, transparent and verifiable transfer charging system is necessary for notified operators to demonstrate non-discrimination and calculate internal costs and revenues for

²³ A good example from Australia is the proposed reporting on mobile roaming, to enable the ACCC to keep roaming pricing under review, when it decided not to regulate roaming in 2004:
<http://www.accc.gov.au/content/index.phtml/itemId/333898>

both cost-orientation and non-discrimination purposes. They typically reflect the vertically integrated nature of notified operators and will enumerate the wholesale/retail relationships between the economic markets and services within the undertaking's scope of activity.

There should be a clear rationale for the transfer charges used and each charge should be justifiable. Charges should be non-discriminatory and there should be transparency of transfer charges in the separate accounts.

Transfer charges should be determined as the product of usage and unit charges. The charge should be equivalent to the charge that would be levied if the product or service were sold externally rather than internally.

For accounting separation purposes it should be assumed that a notified operator's retail business pays the same charge for the same input service as it would (bought on its own wholesale market) if bought externally by an alternative operator.²⁴ [highlighting added

12 Allocation of costs

12.1 A high level of granularity in relation to allocation of costs is required. Additionally, data needs to be drawn from the whole company, not just the business units and services immediately under focus:

2.3 The cost allocation process

....A key factor, which will influence the ultimate usefulness of the costing information, is the level of detail or "granularity" at which costs are initially captured. A high level of granularity (such as the ability to identify asset category information to support the analysis of depreciation charges) - without prejudice to the principles of proportionality and materiality – should be applied. In order to ensure data integrity and the capability to demonstrate that market related information has been extracted properly and reconciles with corporate financial information, **the source costing information will probably need to be drawn from the whole of the undertaking's cost base (including that incurred in the provision of non-SMP markets).**²⁵

This may include the imposition of accounting separation in relation to non-SMP markets. The imposition of accounting separation on non-SMP markets would be compatible with the regulatory framework only insofar as a NRA can justify that the provision of such information is necessary to carry out its regulatory tasks; the imposition of such an obligation must be based on the nature of the problem identified, proportionate and justified, in accordance with the provision of Article 8.4 of the Access Directive. Under the conditions referred to above, the extension of the obligation of accounting separation to non-SMP market would be proportionate since it would be an effective means for the NRA to achieve its regulatory objective.

²⁴ ERG Common Position: Guidelines for implementing the Commission Recommendations C(2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications ("ERG Common Position on Accounting Separation") page 4.

²⁵ ERG Common Position: Guidelines for implementing the Commission Recommendations C(2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications page 5.

*Access by a NRA to the books and records of non-regulated services could be key in relation to the investigation of disputes regarding regulated services as well as the monitoring of non-discrimination obligations.*²⁶

Detailed financial information relating to markets not having SMP designation is of relevance to NRAs in so far as it demonstrates the non discriminatory allocation of costs. To this end, controls related to services supplied in notified markets must demonstrate that the transfer charges paid from the downstream units of the notified operators to the wholesale units of the same operator are similar to those paid by the competitors present in the same downstream market. Such controls may include the use of 'control totals' or a separate set of information for non notified markets reconciled back to the statutory accounts for the aggregate of services supplied to non SMP markets. Failure to do this could result in costs which should be charged to a competitive market being charged to a regulated market with appropriate increases in prices and loss in welfare for consumers or, in reverse, could result in predatory prices or cross subsidies.²⁷[highlighting added]

13 Peering and other issues

13.1 Australia provides an illustration as to how information disclosure, under a similar disclosure regime, can be used to assess whether there are competition problems. In 2004, ACCC discontinued an investigation into peering, which raised issues similar to those that apply here. The main reason it discontinued the investigation was the lack of information²⁸. It noted its concerns about lack of information and the impact on the competition as follows:

The Commission has been unable to make a supportable assessment of the state of competition in the market for Internet interconnection, nor in the downstream markets that rely on interconnection as an input. Therefore, it has been unable to draw verifiable conclusions about the level of competition in these markets. As a result, the Commission has been unable to determine whether declaration would be in the long term interest of end-users (LTIE).

More broadly, the Commission is concerned that an industry as important as the Internet has such poor information available to it. The Commission considers that the lack of basic information on contracts, revenues, costs, network usage, and capacity is indicative of an inefficient industry that is unlikely to be operating at competitive levels²⁹

13.2 ACCC, to achieve objectives including transparency, competition, etc, introduced a disclosure obligation on ISPs so it could gather the necessary information to make an assessment and to inform the ISPs to assist them with negotiations, etc. This requirement was discontinued two years later, after substantial information was obtained, and the cost outweighed the benefit.

²⁶ ERG Common Position: Guidelines for implementing the Commission Recommendations C(2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications page 36

²⁷ ERG Common Position: Guidelines for implementing the Commission Recommendations C(2005) 3480 on Accounting Separation & Cost Accounting Systems under the regulatory framework for electronic communications ("ERG Common Position on Accounting Separation") page 36

²⁸ Regulatory Impact Statement; Page 5 <http://www.accc.gov.au/content/index.phtml/itemId/669213>

²⁹ Regulatory Impact Statement; Page 6 <http://www.accc.gov.au/content/index.phtml/itemId/669213>

13.3 Such an approach would be appropriate here, given the contentions around peering, and the prospect that there are competition issues. This could only be required of Telecom, but that is available under Part 2B.

13.4 Accounting separation is suited to other situations as well. For example, Telecom can be required to report, in relation to bit stream products, both as to costs associated with supplying the service and also the components making up the retail-minus calculation. The Commission, in its submissions to the Select Committee on the Telecommunications Amendment Bill, submitted that retail-minus pricing should be replaced by costs-based pricing. It is within the Section 69Y objectives to track data relating to the costs and the retail-minus components of the bit stream products. Information, for example, may support reconsideration of the retail-minus price (based on new information) or a Schedule 3 investigation into whether to change the pricing from retail-minus to TSLRIC.

14 Availability of information from Telecom

14.1 InternetNZ is surprised at the suggestion that Telecom does not do management reporting down to the level of particular services (wouldn't it do so to enable it to determine the profitability or otherwise of a particular product, like other businesses?). Has it chosen not to update its approach after it became aware of the prospect of legislative change? It should, for regulatory purposes, be required to report with sufficient granularity to provide the Commission, the IOG and other stakeholders with the tools to help deal with issues such as discrimination, price squeeze, etc. The proposed broad-brush reporting for product statements and division-level accounts is well short. Benefit of robust report markedly exceeds cost.

14.2 It is acknowledged there is additional work to do to migrate management accounting to regulatory accounting (for example to make allocation of common cost robust: this can involve complexities). However, the base exists already, as does, as we note below, well-established precedent from NZ and overseas.

14.3 Telecom notes at Para 35, difficulties in separating relevant from non-relevant Wholesale costs and assets. However, if that is necessary for sufficiently robust information disclosure, that should be done, using a rational allocation methodology. Benefit, where justified, will greatly exceed cost.

14.4 Telecom's description of its challenges as to Gen-i is illuminating³⁰:

The Commission excluded gen-i from the list of business units subject to specific business unit reporting. Telecom agrees with this approach because gen-i incorporates both New Zealand and Australian activities. It also incorporates both communications and non-communications revenues. Typically prices are defined for customers across packages including both

³⁰ Telecom submission Para 36.

communications and non-communications services, making isolation of communications revenue difficult. It would be even more difficult to split costs. Telecom proposes to include gen-i in the Other Businesses accounts.

14.5 Gen-i is going to the marketplace with bundled solutions, including for fixed line and mobile telephony services along with other services. Opportunities abound for discrimination and cross-subsidy in the bundles. Shouldn't Telecom be required to provide rational allocations and detail as part of its information disclosure? The ERG guidelines show why that is necessary, if only to ensure that there is adequate disclosure in relation to the key focus of information disclosure.

15 Statement of Capital Investments

15.1 Telecom resists this³¹. For the reasons noted above and in our earlier submission (and adopted in the UK, for example, as to reporting around NGN capex), this reporting should be required. It should be extended to be forward looking and not just historical. It should also cover Telecom's relevant plans and forecasting.

15.2 Telecom notes that even historical disclosure will give an unfair advantage to others, and calls for a level playing field to be maintained.³²

15.3 The current situation is not a level playing field for Telecom's competitors. Telecom is supposed to be consulting on its NGN plans in accordance with the Undertakings. Adequate consultation requires adequate disclosure. Yet Telecom resists this, throwing into question the consultation process.

15.4 As it happens, Ofcom is currently addressing this issue with BT, leading to proposals for greater clarity around information and consultation which BT has accepted.³³ Telecom is committed to consulting its competitors and must disclose for that purpose if it is to consult adequately.

15.5 The structure around Telecom's consultation is uncertain and weak, compared to BT's, particularly after the changes noted in the previous paragraph.

15.6 As adequate consultation requires access seekers to have adequate information, and it appears that Telecom is not adequately disclosing, it is appropriate (and within the Section 69Y objectives) to require sufficient information disclosure to enable adequate consultation, as required by the Undertakings.

³¹ Telecom submission; Para 75

³² Telecom submission; Para 77-78

³³ Variations to BT's Undertakings under the Enterprise Act 2002 in respect of 21C, Space, power and OSS (http://www.ofcom.org.uk/consult/condocs/variations_bt/summary/)

15.7 Telecom notes confidentiality concerns. Confidentiality concerns are a second-level issue. Disclosure to the Commission is one thing: Telecom's legitimate concerns can be handled at the next level: should the information be disclosed to others? The Commission will have a regime to deal with that second level issue.

16 Forward-looking cost reporting

16.1 We welcome Telecom's desire to move in this direction. We have already submitted that current cost accounting is implemented quickly. This must be done correctly.

17 Time within which Telecom provides regulatory audited financial statements

17.1 Telecom seeks to delay the onset of information disclosure. Considerably wider disclosure is appropriate than Telecom proposes, and much of that should commence from the current financial year. (Much of this, and the disclosure as proposed by Telecom, can be done retrospectively and therefore can be completed back to 1 July 2008).

17.2 Telecom seeks 6 months from each balance date to provide accounts (and a longer period after its proposed extended transition period³⁴. The Commission's proposal of 3 months is reasonable, and consistent with the timing for provision of Telecom's standard audited financial accounts.

17.3 BT, which is much larger and more complex, must provide its several hundred pages of regulatory audited financial reports within 4 months of balance date³⁵.

17.4 For the year ending 30 June 2009, Telecom proposes to provide its accounts one year later (i.e.; there would be no reporting at all until 30 June 2010 (around 3 ½ years after the requirement was enacted)). Telecom says these accounts should not be audited except, maybe, beyond the level of auditing the methodologies.

17.5 For the next year (the year ending 30 June 2010) Telecom proposes to report 9 months later (by 31 March 2011)³⁶.

17.6 Neither delay is justified. Reporting within 3 months of balance date should start from the current financial year, for the reasons noted in our earlier

³⁴ Telecom submission; Page 5

³⁵ Condition OA6(b): <http://www.ofcom.org.uk/consult/condocs/defer/statement/>

³⁶ Telecom submission; Page 5

submission, unless Telecom can clearly demonstrate reasons for modest delay.

- 17.7 Product statement reporting should commence from the current year and not be deferred, as Telecom suggest. For the reasons stated above and in our earlier submission, this is both achievable and appropriate.
- 17.8 There are some complexities, such as achieving sufficient rationality around cost allocation of common cost. However, there is a considerable body of experience and written regulatory guidance internationally, from which the Commission and Telecom can develop the approach. The Oftel experience noted by Telecom is not relevant. This is some years later, when there is much more information and process precedent available.

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