



Telecom New Zealand Limited

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**

Public Version

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A EXECUTIVE SUMMARY

- 1 As stated in its previous submission in July this year, Telecom remains committed to working with the Commission to develop robust but workable regulatory financial reporting. We remain of the view that cost-effective regulatory accounting requirements which meet the purposes of the Act are readily achievable provided a sensible approach to defining those requirements is taken.
- 2 In seeking to strike a sensible balance of costs and benefits, it is instructive to refer once again to the purpose of these accounts: The Telecommunications Act 2001 (the "**Act**") requires a level of financial reporting sufficient to inform a wide range of people of the operation and behaviour of Telecom's operationally separated units, which must be reasonable having regards to the time required to prepare the information.

Accounting separation requirements must be reasonable

- 3 Telecom agrees that certain core aspects of the proposed financial reporting requirements are necessary to enable the Commission to deliver on the purpose behind the financial reporting requirements and to meet its objectives. These include most of the regulatory financial statements proposed by the Commission. However, many of the other requirements set out in the Commerce Commission's (the "**Commission**") Draft Notification of Information Disclosure Requirements issued on 23 October 2008 (the "**Draft Notification**") contain little reference to, or consideration of, the Act's purpose and go well beyond it.
- 4 For example, it is difficult to see how any of the following aspects of the Commission's draft requirements advance any of the Part 2B purpose statement, or are supportable in policy:
 - (a) **Detailed disclosure of Telecom Wholesale's commercial, non-regulated, non-relevant services:** Imposing regulatory costs on commercial services, which are not subject to Telecom's Operational Separation requirements is directly contrary to the purpose of the Act, and there is no explanation in the Commission's paper as to the benefit this reporting will provide; and
 - (b) **Compliance Monitoring requirements:** These are simply more detailed versions of the information the regulatory financial statements the Commission is requiring Telecom to prepare, will not in the main be publicly disclosable, and will not be prepared in a manner which would enable them to be used for regulatory price setting. It is not clear what purpose this reporting would serve if any, it does not provide a wide range of people with useful information, and adds significant cost to the accounting separation requirements.

- 5 As a result of additions such as these, the draft requirements, issued eight months before the end of the transitional financial year, have significantly altered from discussions which commenced with the Commission over a year ago, and from the Commission's draft principles paper published in June this year. At a practical level, the all encompassing requirements proposed can not be complied with in the timeframes proposed - either from a systems or a people perspective.

The pre-existing operational separation of Telecom must influence the scope and extent of accounting separation requirements

- 6 The Act also states that any accounting separation requirements must be consistent with the operational separation requirements on Telecom. 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 set-up costs of accounting separation are significant, and the objectives of accounting and operational separation overlapping. The existence therefore of operational separation in New Zealand before accounting separation *must* influence the design of the accounting separation requirements, and common sense suggests this *must* mean less onerous and costly requirements than are found in jurisdictions which do not have operational separation, or which have implemented accounting separation before operational separation.
- 7 Requirements that are not necessary to achieve the purposes of the Act and which duplicate other regulatory requirements are not best regulatory practice.¹ The Commission risks imposing unworkable solutions and highly onerous administrative compliance costs on Telecom for what seem to be unclear and potentially non-existent benefits.

The requirements as proposed are unachievable in the stated timeframes, and exorbitantly expensive

- 8 To deliver the requirements in the Commission's Draft Notification Telecom would now need to develop and test new systems, recruit and train new people, engage with the Commission to finalise methodologies, engage with auditors and prepare draft accounts. None of these matters have short finite timeframes, yet it is clear from the Commission's draft requirements that the extent and cost of these exercises has either not been considered at all, or has been vastly underestimated.
- 9 Telecom has been developing an activities based management system ("**ABM**") in good faith for the last 18 months, and has briefed the Commission on its development. The draft requirements and methodologies proposed are

¹ In its press release no 55, Issued 5 November 2008 the Commission noted that the "Commission is mindful of the need to minimise compliance costs for the industry..."

inconsistent with the design of that system, and would require the development of a new Regulatory Cost Allocation System. Telecom estimates that to build this new system to meet the requirements would cost an estimated \$5 million and require a number of additional staff. With such a significant build, there is a corresponding time implication. Telecom simply could not develop, test, and populate in the timeframes suggested by the Commission

- 10 New processes and procedures to capture the additional information required by the Draft Notification would also need to be developed. For example, capital investment information is not recorded in the manner, or with the detail requested by the Commission. The existing system would need to be modified to ensure that these details could be captured and then the modified system would need to be updated to include existing information. Similarly, for the information requested in the schedule of the network component and network activity, Telecom would need to build another new system from scratch.
- 11 On top of these systems costs would be audit and consulting costs, which again under the Commission's proposal would be significant. As a number of these systems have not been subject to the scrutiny of an audit previously, the level of audit required by the Commission of those systems (once in place), methodologies and financial statements would cost an estimated \$5 million dollars. Similarly, we estimate consulting fees related to the development of new systems and capabilities would match this figure again.
- 12 These costs in totality are exorbitant, and must test the limits of any sensible cost benefit analysis.
- 13 Costs aside, even if the relevant skilled staff were immediately available, which is not the case, it would still not be possible to develop the required systems and test them in the required time frame.
- 14 If the Commission removes the unreasonable requirements identified in our submission, Telecom will be able to meet the alternative timelines it has proposed for the transitional year (2008/09) that would see it delivering audited accounts in February 2010 with a "fairly presents" audit opinion or December 2009 with a "properly prepared in accordance with" audit opinion. For the 2009/10 financial year Telecom would aim to accelerate the process in order to deliver accounts with a "fairly presents" audit opinion in December 2010. In order for Telecom to be able to meet these timeframes the Commission would need to sign off key matters during the process to enable it to develop systems and methodologies.
- 15 Telecom looks forward to working with the Commission over the coming months to deliver on its financial reporting commitments.

B THE REQUESTS IN THE DRAFT NOTIFICATION

Progress to date

- 16 Telecom has undertaken a significant amount of work in the past 18 months in order to prepare for and ensure it would be able to deliver regulatory accounts. To this end it has spent a lot of time and money developing systems and processes that would help it to deliver on its obligations. Telecom has developed these systems in line with overseas precedents and what it is required to deliver under the Act. Some examples of the work undertaken to date:
- (a) a comprehensive update of its fixed asset register to remove assets no longer in use;
 - (b) a revaluation of all network and related assets on a current cost accounting (CCA) basis;
 - (c) development of a system that enables it to measure equivalence of in service delivery;
 - (d) development of an internal trading regime; and
 - (e) a comprehensive mapping of operational costs to processes, business units and products using an Activity Based Management model.
- 17 Much of the work has been done with the help and guidance of international consultants. A lot of money has been spent by Telecom so that these models could be readily developed to meet the expected needs of the Commission and Government and to ensure that Telecom would be able to meet the tight timeframes that were likely to be imposed. Further, Telecom has engaged with the Commission on a regular basis to help foster understanding of Telecom's systems and the work that Telecom was doing, and to ensure that what we were doing would meet the Commission's needs.
- 18 The Commission issued a Draft Principles Paper issued on 20 June 2008 (the "**Draft Principles Paper**") that provided more details about the Commission's thinking on Accounting Separation, but the Draft Notification has made it clear that its thinking has changed considerably since then.² The Draft Notification includes a number of requirements that have not been previously contemplated by Telecom, and which were not discussed or considered in the Commission's Draft Principles Paper.

² See the Commerce Commission's *Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom*, issued 20 June 2008

Practicability of the proposed requirements

- 19 Unfortunately, even with the work that Telecom has done in anticipation of the release of the Commission's requirements, Telecom's assessment is that it will be **impossible** for Telecom to deliver everything that has been requested by the Commission's Draft Notification in the proposed timeframe. The main reasons for this assessment are;
- (a) the systems and processes that would need to be developed to support the Commission's requirements;
 - (b) the number of people that would be required to deliver the requirements; and
 - (c) the time it has taken overseas telecommunications companies to implement Accounting Separation requirements.

We discuss these three aspects in more detail below.

Systems

- 20 The Draft Notification requires Telecom to produce information that is not currently contained in Telecom's systems, as well as information that will require modifications to Telecom's systems. Therefore, before Telecom is able to produce the regulatory accounts it needs to develop or modify systems to ensure that the relevant information is available. There is not sufficient time before the first accounts are due to develop/modify the necessary systems.
- 21 The clearest example of this is the time it would take to develop a new Regulatory Cost Allocation system. Telecom has been working on its ABM system to allocate costs to business units and ultimately to products for the past 18 months. Telecom's best estimate is that it will take another 6 months to complete this work. A new Regulatory Cost Allocation system would take Telecom back to where it started with the ABM system and given the Commission's specific requirements Telecom would not be able to use an "off the shelf" model that had been well tested. The new Regulatory Cost Allocation system would clearly be a major undertaking and it would be impossible to develop, test, and populate this new system in the timeframes suggested by the Commission.
- 22 Other new processes and procedures would also be required:
- (a) to deliver the capital investment information, as it is not recorded in the manner, or with the detail requested by the Commission. The existing system Telecom has would need to be modified to ensure that these details could be captured and then the modified

system would need to be updated to include existing information;
and

- (b) to deliver the network component and network activity information that the Commission has requested from Telecom. To do this it would need to build a new system from scratch.

- 23 Building and updating system functionality is a very time consuming and expensive exercise. Telecom estimates that the new systems requirements would cost approximately five million dollars and require a significant number of additional staff.
- 24 Additionally, a number of these systems have not previously been subject to the scrutiny of an audit. There would need to be a major data cleansing exercise to get the data to the standard required for its new purpose, this would take time and resource. The audit of those systems (once in place), methodologies and financial statements would cost a further estimated five million dollars.

Staffing

- 25 Telecom's initial estimate is that it could take about an additional 40 full time staff (Telecom already has a team of 12 people working to ensure it will be able to provide the regulatory financial statements required by the Commission), plus contractors and auditors to deliver what the Commission has now requested. The skilled staff required to deliver on the Commission's requests are not available in the New Zealand labour market in the timeframes required by the Commission.
- 26 Even if Telecom were able to recruit an additional 40 people, we would expect that to take at least 6 months, and that they would take a further 3-6 months for them to get up to speed with the project.

Overseas experience

- 27 Overseas experience suggest that it takes significantly longer than seven months to develop regulatory financial reporting.
- 28 Australia is a good example of the iterative nature of the implementation of regulatory financial reporting. What has been required of Telstra has changed incrementally over the last seven years. The ACCC has given Telstra the time it needed to develop the different systems and to collate the relevant information needed for their regulatory financial reporting requirements.
- 29 Similarly, in the United Kingdom BT's regulatory accounts have been evolving over the years as both BT and the regulator have better understood what is required. BT now has a comprehensive reporting regime that has been built over thirteen years.

- 30 In Ireland, Eircom were given six months to prepare their first set of HC accounts with a "properly prepared in accordance" audit opinion, it took them seven months. In the second year they were required to prepare HCA and CCA with a "properly prepared in accordance with" audit opinion within three months, it took them eight months for the HCA accounts and nine months for the CCA accounts.
- 31 Particularly in light of the quantity of information that has been requested, Telecom's assessment is that, as has been seen in other countries, it will not be able to deliver what has been required from it in the timeframe it has been given.

Reasonableness

- 32 Even if it were possible, Telecom considers that it would be unreasonable for the Commission to expect Telecom to incur the time and resources needed to deliver on the Commission's current requirements. The reasonableness of a request is relevant because section 69Z of the Act requires that the Commission takes into account the time (and implicitly the cost) it will take to prepare information when deciding what information is necessary to achieve the purpose of this section of the Act.³
- 33 It is important to note that New Zealand case law is quite clear that even wide powers have legal limits. In *Wellington City Council v Woolworths New Zealand Ltd* (No 2) the court stated:⁴

[An Authority] must observe the purposes and criteria specified in the legislation. So they must call their attention to matters they are bound by the statute to consider and they must exclude considerations which on the same test are extraneous. They act outside the scope of the power if their decision is made for a purpose not contemplated by the legislation. And discretion is not absolute or unfettered, it is to be exercised to promote the policy and objectives of the statute.

- 34 When commenting on this case a leading commentator has noted:⁵

Although Parliament typically confers wide discretions when empowering public authorities, every discretionary power has legal limits. Unfettered discretion cannot co-exist with the rule of law and constitutional government ... Every discretionary power is circumscribed by the statutory objects and must be applied in furtherance thereof.

- 35 This mandatory requirement is crucial because it acknowledges that when developing Telecom's regulatory financial reporting requirements the Commission is making trade offs on Telecom's behalf. It is a fact that the more complex the process the more time and money it will take Telecom to produce

³ See section 69Z of the Telecommunications Act 2001 which states "*The Commission's requirements under this Part must be reasonable, having regard to the purpose of this Part, the confidentiality of the information in question, and the time required to prepare the information.*"

⁴ *Wellington City Council v Woolworths New Zealand Ltd* (No 2) [1996] 2 NZLR 537 (CA) at page 54.

⁵ Phillip Joseph commenting on Richardson P's comments in *Constitutional and Administrative Law in New Zealand* (3rd ed, Brookers, 2007) at page 849.

- the information. That is time and money that is not able to be used by Telecom delivering better services to New Zealanders.
- 36 The time it will take to prepare the information provides a good indication of what is reasonable. This is particularly relevant to what is being required in the transitional year because Telecom will have less than 7 months in which to develop and test its systems and processes. The extent of the requirements will have a direct effect on what Telecom is able to deliver for the 2008/09 financial year.
- 37 It will also provide a good indication of what is reasonable in future years. Where a requirement is going to be incredibly time consuming it should be natural for the Commission to question whether, to meet the objectives of this part of the Act, the information is necessary, necessary in the level of detail contemplated or could be obtained from another source.
- 38 Our initial estimate is that it would cost around 15-20 million dollars and require approximately 50 people (including existing staff), with the major costs being:
- (a) the development of a new Regulatory Cost Allocation system, different to the ABM system that Telecom has been working on for the last 18 months. This would cost an estimated 5 million dollars;
 - (b) there would be additional staff (both permanent and contract) to assist with the development of processes and procedures to deliver accounting separation at a cost of approximately 3 million dollars);
 - (c) the audit of the systems, methodologies and financial statements which would cost an estimated 5 million dollars; and
 - (d) consulting fees of 5 million dollars.
- 39 As the time, cost and complexity associated with a request increases the balance between these factors and the purpose of the Act should come sharply into focus. This will allow a robust assessment as to whether a sensible balance is being achieved.

Operational Separation

- 40 When considering what is reasonable the Commission must also take Operational Separation into account. It is reasonable to expect that Operational Separation and Accounting Separation will be developed in a complementary manner, particularly in light of the provision in the Act that states that the Commission's Accounting Separation requirements are to be consistent with the

Undertakings.⁶ By ensuring they align the Commission will be able to ensure that the Operational Separation Requirements and the Accounting Separation requirements do not result in any duplication of effort.

- 41 Taking Operational Separation into account also acknowledges that New Zealand is unusual in the fact that it has implemented operational separation prior to accounting separation. Operational separation is a more intrusive remedy, which comprehensively addresses concerns regarding price and non-price discrimination, EOI standards, and the potential for cross-subsidisation in a transparent way. It affords the industry and the regulator much greater transparency of the internal supply of regulated services than accounting separation could ever do. It is important that the Commission does not overlay another type regulation to address concerns that are dealt with through operational separation.
- 42 If we take non-discrimination as an example, the Commission has stated that detailed financial reporting is required to support non-discrimination; we have presumed it wants the information to confirm that discrimination is not taking place.⁷ The proposed financial reporting information is not required for that. The Operational Separation Undertakings mean that Telecom cannot discriminate between internal and external customers because for:
- (a) regulated services, customers of Chorus and Wholesale are to receive those services to an Equivalence of Inputs standard.⁸ This means that Chorus and Wholesale are required to provide all their customers, both internal and external, with *exactly the same service*;⁹ and
 - (b) non regulated services which Chorus and Wholesale provide to both internal and external customers, they are required to be provided on *non-discriminatory* terms.¹⁰

⁶ Section 69 ZB (4) of the Act states that: *Any requirements under this section must be finalised only after a separation plan has been approved under Part 2A, and must be consistent with the separation plan.*

⁷ Paragraphs (iii) and 2 of the Commerce Commission's *Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom*, issued 20 June 2008 and the Commission again makes reference to these goals in its media release, no 049, issued 23 October: *Commerce Commission releases draft requirements paper on regulatory financial reporting by Telecom.*

⁸ See clauses 21 and 47 of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001.*

⁹ See clause 1.2 of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001.*

¹⁰ See clauses 40 and 51 of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001.*

- 43 The Undertakings requirements also ensure that the Commission will be able to check Telecom's compliance with these requirements by reviewing the trading arrangements that Chorus and Wholesale are required to enter into.¹¹ These arrangements detail the terms, including price, on which these services are supplied. The Commission does not need any additional financial information to assess whether Chorus and Wholesale are acting in a non-discriminatory fashion.
- 44 The public will also have details on whether discrimination is taking place through the, publicly available, audited annual report from the Independent Oversight Group.¹² This will present the IOG's conclusions on whether Telecom is complying with its undertakings requirements.
- 45 Non discrimination provides a clear example of why the New Zealand context justifies a more targeted form of accounting separation. It should not require: the Commission, the IOG, Telecom's trading arrangement documentation, Telecom reporting to the IOG, reporting by the IOG, an audited annual report from the IOG, audited regulatory financial statements and regulatory compliance monitoring information to confirm whether Telecom is discriminating in favour of its own business units. In addition to this information it must also be remembered that where the Commission has specific concerns it has the power to make a specific information request under section 98 of the Commerce Act. Telecom considers that a subset of this information would be sufficient.
- 46 Throughout the Operational Separation process Telecom has demonstrated it takes its regulatory commitments seriously. Similarly, Telecom is committed to working with the Commission to develop robust regulatory financial reporting. However, Telecom has already committed a huge amount of resource to Operational Separation and it is concerned that it should not be required to commit unnecessary resources to another regulatory intervention. If time, cost and complexity can be cut from the accounting separation models, without compromising the overall objective of this section of the Act, it will ultimately be to the benefit of end users of telecommunications services.

The financial reporting requirements that are reasonable

- 47 Telecom acknowledges that there are a number of key requirements which are necessary to enable the Commission to deliver on the purpose of this section of the Act that is set out in section 69Y of the Act. This purpose is to make information publicly available to inform a wide audience about Telecom's

¹¹ See clauses 32 and 57 of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001*.

¹² See clause 85 of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001*.

business activities.¹³ Telecom notes that the Commission has interpreted this to mean that the financial accounts should provide transparency, identify cross subsidies and to support non-discrimination.¹⁴

- 48 The financial statements that Telecom agrees that it is reasonable to ask for are set out in appendix B.

The unreasonable financial reporting requirements

- 49 However, Telecom has also identified a number of requirements from the Draft Notification which it thinks are unreasonable for the Commission to require delivery of because they are not required to meet the Commission's objectives or the purpose of this section of the Act. Telecom discusses these below.

Telecom's ABM system

- 50 A new Regulatory Cost Allocation system is not reasonable in light of the time it would take to develop this. It is unclear in the Draft Notification paper whether Telecom will be able to use its ABM methodology. The attribution methodology in Appendix E of the Commission's Draft Notification differs from Telecom's ABM methodology. Under Activity Based Costing generally, costs are recorded first to activities, and then driven to cost objects such as products or services. Telecom's ABM implementation follows this approach and uses a two stage process. Firstly, there is a dynamic cascade of costs to either customer facing business units directly or to shared service models. Costs that are captured by the shared service models are directly or indirectly driven to the business units based on either causation or allocation. The Commission's methodology is different because:

- (a) 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 be 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; and
- (b) it does not make reference to materiality, It requires all costs to be driven on the basis of causality, regardless of materiality. This is inconsistent with the ABM methodologies that Telecom has been guided by, and implemented.

The key differences are shown in the diagram in appendix C.

¹³ Section 69Y of the Telecommunications Act 2001.

¹⁴ Paragraphs (iii) of the Commerce Commission's Draft Principles and Regulatory Reporting Requirements for the Accounting Separation of Telecom, issued 20 June 2008.

- 51 Telecom has had a team working on this ABM for the last 18 months. If it is not able to use ABM it would have to develop another Regulatory Cost Allocation system from scratch. This would mean it would have to set aside the work that has been done and it would need to:
- (a) employ additional full time staff to develop the system;
 - (b) Telecom's initial estimate of what it would have to spend to develop a new Regulatory Cost Allocation system is 5 million dollars (this figure is exclusive of consultants fees); and
 - (c) Telecom estimates it would also need to spend another 5 million on consultants (again, whether there are consultants available to do this work is unclear).
- 52 Telecom considers it would be unreasonable not to allow it to use its ABM system, particularly in light of the fact that the Commission has stated that it wants to utilise as many of Telecom's financial systems as possible.¹⁵ This is a system that will be key to Telecom's regulatory financial reporting.

Compliance monitoring

- 53 Telecom considers that the Commission's request for compliance monitoring information under section 69ZF(1)(b) of the Act is unreasonable. This information is to be supplied in addition to the Regulatory Financial Statements that Telecom will be making publicly available and would require Telecom to spend a large amount of time updating and developing systems to deliver this information.
- 54 Telecom questions how this would further the purposes of this section, particularly when the information provided will have been audited. Below Telecom provides an assessment of why each of the pieces of compliance monitoring information is unnecessary:
- (a) **Detailed Regulatory Statement of Assets for Wholesale and Access Services** – These statements are simply more detailed versions of the statement of financial assets that will be made publicly available. Receiving the same information in more detail does not enable the Commission to conduct a compliance check, it just means that the Commission has a set of more detailed information;
 - (b) **Regulatory Statement of Capital Investment** – The statement of capital employed and statement of assets provide adequate

¹⁵ See paragraph 6, of the Commerce Commission's *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

information on investments and these will be audited. The time and cost associated with preparing this statement outweigh any benefit;

- (c) **Schedule of Network Components and Network Activity Statement** – As the Commission does not require any other network capacity information it will be difficult to see how this can be requested to *monitor a persons compliance with the requirements made under Part 2B of the Act*. As discussed below, section 69ZF is about checking for compliance and not about requesting new information; and
- (d) **Standalone and Variable Unit Costs** – This data will not be able to used for comparison/compliance monitoring purposes because it will rely on different methodologies to the ones used for setting regulatory prices. So again, on that basis it is difficult to see how this can be requested to monitor compliance.

- 55 Telecom wants to be clear that in objecting to the proposed compliance monitoring regime Telecom is not trying to hide information. Its concern relates solely to the time and cost associated with establishing and maintaining this type of regime. If after reviewing the audited report the Commission still wanted to check Telecom’s compliance the Commission could make a targeted information request under section 69ZF and Telecom would be happy to comply with a reasonable request.
- 56 The Commission has also noted that information from the compliance monitoring reports will enable the Commission to monitor the implementation of the access principles and the equivalence of inputs requirements embedded in the operational separation undertakings which are set out in Part 2A of the Act.¹⁶ It is important that this is irrelevant to the section 69Z assessment of whether it is reasonable to request this information. Section 69ZF can only be used to obtain information to monitor compliance with the regulatory financial reporting requirements that are established under Part 2B of the Act. It is not appropriate to use the section to obtain other information that the Commission would like to enable it to help it to carry out its other regulatory functions, and in particular Part 2A of the Act.
- 57 Finally, even if the Commission could justify obtaining the information it has asked for, Telecom is concerned that the Commission may be overestimating the utility of that information. For example, the cost information that will be supplied will be based on Telecom’s current network. The costing methodology that the Act requires to be used for regulatory purposes is a TSLRIC methodology. The TSLRIC calculation is based on the forward looking costs of

¹⁶ See paragraph 13, of the Commerce Commission’s *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

an efficient operator. There are three key differences between this and the unit cost data the Commission has requested Telecom to provide:

- (a) The actual costs of an incumbent operator – particularly where these costs reflect network assets put in place over the past 50 or so years – are likely to differ materially from forward-looking costs;
- (b) The allocation of common costs may not match what would have been provided for in a TSLRIC calculation; and
- (c) There may be differences between depreciation approaches meaning that Net Book Values (and the unit costs based on them) could differ even if Gross Book Values were the same.

Wholesale as a single reporting unit

- 58 Telecom's view is that it is unreasonable for the Commission to expect it to split the Wholesale service group's accounts into regulated and commercial services when for all other purposes Wholesale is treated as one service group and the service groups costs are almost all shared. If Telecom is forced to split Wholesale's accounts it will result in arbitrary allocations which will mean the information will be of little use. The artificial distinction that is proposed by the Commission would result in a lot of time being spent splitting the units costs and assets between the different "parts" of the business.
- 59 Telecom's view is that the split would be a time consuming and artificial exercise. It would take at least two months to review all of the revenues and expenses of Wholesale to split them into the segments suggested. The result of this would still be artificial as shared costs (such computer costs, marketing and office expenses) would need to be split between the two segments. Splitting Wholesale is not necessary to facilitate the Commission's objectives of identifying cross-subsidies and supporting non-discrimination and that it cannot be justified on the basis of transparency alone.
- 60 The Commission can obtain the information necessary to detect cross subsidies by reconciling the product statements that will have been supplied for key regulated services and the Wholesale services group's statement of financial performance. Through this reconciliation the Commission will be able to work out the profitability of the regulated and non-regulated services. This calculation provides information that is comparable to what you would get from separate Statements of Financial Performance in a fraction of the time.
- 61 As discussed in section 46-49 above, Telecom's commitments in the Undertakings ensure that Telecom cannot discriminate for Relevant Services and the information on Telecom's performance will be available to the public. The Commission does not need financial information in addition to all the other information that will be made available.

- 62 While the split may provide transparency, transparency for transparency's sake does not provide the justification for the time it will take for Telecom to split the Service Groups in the manner proposed by the Commission.
- 63 It is also important to note that transparency usually means providing users of accounts with information that a Company itself has. In this case the Commission is asking Telecom to create a new set of information which does not seem reasonable.
- 64 Finally, treating Wholesale as one Service Group is consistent with the Undertakings. This is crucial because section 69ZB (3) of the Act requires that the financial reporting requirements that are developed are consistent with the Undertakings. This provision should help avoid regulatory duplication and provide a useful cross-check that what is being asked of Telecom is consistent with what is being asked of Telecom under the Undertakings. With this in mind it is surprising that the Commission has only addressed the issue of consistency with the undertakings in regard to the issue of service groupings.¹⁷ There are other key areas where consistency is important.

Use of Historic Asset Values

- 65 Telecom does not consider that it is reasonable for it to have to produce product statements based on historic costs. While it is not difficult to calculate asset values based on historic cost, the difficulty comes in assigning these historic values to business units and particularly products.
- 66 The current cost accounting valuation generally takes the physical quantity of the asset and then multiplies that by the current cost for a unit of that quantity. This gives the gross replacement cost for asset.
- 67 Take trenching costs, the single largest cost item, as an example. In the current cost accounting valuation, we obtain the total length of trenches by area, and then multiply that by a cost per metre appropriate for that area. This gives a total cost for trenching. This cost can then be divided between business units on the basis of which business units have cables or ducts in that trench. The exact way this is apportioned can take a variety of forms – all of them arbitrary. However the key point is that because we know the trenching cost, and because we know what cables/ducts are where (and who uses them) it is possible to apportion costs (albeit in some arbitrary manner).
- 68 In the Historical Cost valuation this is not possible. First there is no (or little) physical information associated with our Fixed Asset Register (FAR). We do not know, for any entry in the FAR, how many ducts and cables might be in that trench, let alone who uses them. We have no basis for allocations. Worse, the

¹⁷ See paragraph 9, of the Commerce Commission's *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

FAR records have the trenching assets in numerous different places. In some cases they are associated with cables and recorded as a cable cost. In other cases they are associated with ducts and manholes. In other words there is no category that contains solely trenching costs and all trenching costs. Nor can we go back and separate it out of say the cable costs. So not only can we not allocate historical trenching costs, we cannot even identify how big they are.

- 69 Further Telecom believes that the depreciation based on historic costs is inconsistent with the economic depreciation approach the Commission has used in other regulatory contexts (for example the TSO). We have referred to this combination of using the current replacement cost of the asset, together with an economic view of depreciation, as the Economic Cost Accounts (ECA).

Audit

- 70 It would seem reasonable for the Commission to adopt a transitional year for the audit requirements as well as the regulatory financial statements. The transitional year would reflect the fact that there will be a significant amount of learning for the auditors, Telecom and the Commission during the 2008/09 financial year. The scope of the financial reporting requirements would be extended during the 2009/10 year once the parties have a working knowledge of what is required.
- 71 The transitional year would ensure the Commission is able to gain assurance as to the processes, procedures and alignment between the regulatory accounts and the Commission objectives. The auditors will be well placed after the initial year to deliver the full audit during the 2009/2010 financial year.
- 72 Telecom proposes that the audit requirements should be as follows:

| | 2008/09 | | 2009/10 | |
|--|---------|-----|---------|-----|
| | HCA | ECA | HCA | ECA |
| Initial regulatory manuals | | | | |
| Audit opinion on whether the Regulatory Manuals identify and document relevant systems, processes and information sources that are being or will be used to prepare the regulatory financial statements. | ✓ | ✓ | | |
| Audit opinion on whether the Regulatory Manuals are consistent with the Commission's written requirements | ✓ | ✓ | | |
| Audit opinion on whether pro-forma statements are consistent | ✓ | ✓ | | |

| | | | |
|---|---|---|---|
| with the Commission's written requirements | | | |
| Audit opinion on whether the Regulatory Manuals accurately reflect any material changes to processes or procedures made by Telecom or required by the Commission. | | ✓ | ✓ |
| Regulatory Financial Statements | | | |
| Audit opinion on whether each regulatory financial statement complies with the Commission's requirement | ✓ | ✓ | ✓ |
| Audit opinion whether each regulatory financial statement has been prepared in accordance with the relevant regulatory manuals | ✓ | | |
| Audit opinion whether each regulatory financial statement is fairly presented. | | ✓ | ✓ |
| Audit opinion on whether anything has come to their attention that leads them to conclude that the regulatory manuals have not been properly applied in the preparation of the relevant regulatory financial statement. | | ✓ | ✓ |

- 73 This is also consistent with what has happened in overseas jurisdictions. In particular in Ireland, Eircom was required to have the first two set of accounts audited with a "properly prepared in accordance with" audit opinion. The third year a "fairly presents" opinion was required. Telecom suggests a similar transitional audit process be adopted by the Commission.
- 74 In addition to this the level of materiality that is set for the audit has a significant impact on the ability of Telecom to meet the deadlines proposed. Telecom proposes that a 31 December 2009 deliverable would be achievable if a "properly prepared in accordance with" audit opinion is provided, with a group materiality used in audit procedures. Should a "fairly presents" audit opinion be required Telecom would not be able to deliver the audited regulatory accounts until the end of February 2010.

Audit assurance

- 75 It is also noted that the requirements and scope of audit of the regulatory financial statements are significantly more onerous than those that are required for the audit of Telecom's statutory financial statements. In particular, the Commission has proposed that the auditor forms an opinion "to the highest

level of assurance.¹⁸ This is an unusual request as this is the level of assurance associated with forensic accountancy. There is nothing in the regulatory accounts to justify a higher level of assurance and accordingly, the *positive assurance* used for Telecom's statutory accounts seems appropriate.

Draft audit opinion

- 76 We also note that the Commission has proposed that Telecom deliver a draft audit opinion.¹⁹ This seems unnecessary as it adds time and cost to the process without any corresponding benefit. Again, this is not standard practice and is not required for Telecom's statutory audit process. It also seems unduly onerous given that Telecom will be meeting with the Commission monthly to give them updates on progress.

Alternative regulatory auditor

- 77 Finally, the allowance for an alternative regulatory auditor is unreasonable. This is not standard practice and would undermine the independence and integrity of the firm Telecom appoints as the regulatory auditor. It would also seem strange for the Commission to lose confidence in an auditor which they have approved. Telecom is of the firm view that this provision must be removed.

C TELECOM'S PROPOSAL

- 78 Telecom acknowledges that the core regulatory financial statements specified by the Commission in appendix A of its Draft Notification paper will help it to deliver the Commission's objectives. However, beyond the core financial statements there are number of things that the Commission have asked for which will be of limited utility.
- 79 Telecom proposes the following changes to the Commission's draft requirements to ensure Telecom can deliver a robust set of financial accounts in a reasonable time frame.
- (a) Acceptance of Telecom's ABM methodology;
 - (b) Removal of Compliance Monitoring requests;
 - (c) Wholesale be considered as one service group;
 - (d) Product statements to be based on forward looking costs only; and

¹⁸ See page 21, of the Commerce Commission's *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

¹⁹ See Appendix C, of the of the Commerce Commission's *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

(e) Transitional audit provisions.

- 80 Telecom attaches its proposed transitional and reporting milestones in Appendix A. Under Telecom's proposed transitional milestones it would deliver its first set of regulatory accounts on 27 February 2010, with a "fairly presents" audit opinion. Telecom still considers this timeframe to be tight, but it is achievable. Should the Commission accept a "properly prepared in accordance with" audit opinion in addition to Telecom's proposal, Telecom believes it could deliver the first set of regulatory accounts on 31 December 2009.
- 81 Under the Telecom proposal the 2009/10 regulatory accounts would be delivered on 31 December 2010.
- 82 The removal of the unreasonable requirements that have been identified above is key to Telecom being able to meet these deadlines. If any of these requirements were to stand Telecom would need to reassess these timeframes.

Key matters to enable a reasonable approach in the proposed timeframe

- 83 The other key aspect to Telecom being able to meet these timeframes is that the Commission signs off matters to allow Telecom to develop its processes and methodologies. The development of the processes and methodologies during the transitional year will be an iterative process, but at the same time Telecom needs certainty to enable it to proceed with certain matters. The key things Telecom will need signed off are set out below:

(a) Telecom will need the following matters signed off by 14 November 2008:

- i. The use of the ABM model to allocate opex costs;
- ii. The use of the same valuation methodology that Telecom used to value the Chorus assets;
- iii. The pre and post tax WACC rate that is to be used;
- iv. What parts of Telecom are contained within each service group to enable Telecom to establish how this relates to the current Telecom business structure;
- v. The form/presentation of the regulatory financial statements. We have attached the accounts that accompanied our submission dated 18 July on the Commission's Draft Principles Paper at appendix D. Telecom considers that these accounts meet the Commission's objectives without creating unwieldy reports that are difficult to use; and
- vi. The matters to be discussed at each of the monthly update meetings.

- (b) To ensure the models that are built are able to be used during the 09/10 financial year, the Commission would need to sign off the products that that were to be included as regulated services prior to 1 December 2008. Telecom discusses the products which it thinks statements are appropriate for at paragraphs 86 to 91 below.
- (c) Finally, to enable the tender for the regulatory audit work to be issued the following key points would need to be signed off by the Commission prior to 1 December 2008:
 - vii. Agreement of proposed list of audit tender candidates (from PricewaterhouseCoopers, Deloitte, KPMG, Ernst and Young, BDO Spicers and Grant Thornton);
 - viii. The audit process and scope;
 - ix. The form of audit opinion ("prepared in accordance with" or "fairly presents"); and
 - x. The materiality threshold.

D. MATTERS FOR CLARIFICATION

Telecom's mobile business

- 84 The Commission is silent on whether accounting separation requirements will extend to Telecom's mobile business. As it would be inconsistent with the Undertakings to include information relating to mobile services, Telecom is proceeding on the basis that the financial reporting requirements will not extend to those services.²⁰²¹

Definition of CCA

- 85 NZ GAAP does not define CCA or any methodologies able to be used to complete CCA valuations. Telecom is preparing the financial statements required under Accounting Separation using assets valued on a current cost accounting basis as this corrects a number of inherent limitations in historical cost accounting (see paragraphs 66 - 69 above). The depreciation of these assets is to be calculated on an economic basis. As already noted, this is consistent with the Commission's approach to depreciation elsewhere.

²⁰ Section 69ZB (3) of the Act requires that financial reporting requirements that are developed under Part 2B of the Act must be consistent with the Undertakings.

²¹ See clauses, 4, 18.2 (c)(iv) and 45.2 (vii) of the *Telecom Separation Undertakings as provided to the Minister of Communications on 25 March 2008 in accordance with section 69K (2)(c) of the Telecommunications Act 2001*.

List of product statements.

- 86 Telecom notes that the Commission has only asked for regulated services.²²As set out in our submission on the Draft Principles Paper Telecom understands that to mean “key regulated services” and more specifically the key regulated input services for which charges have been identified in Standard Terms Determinations (Telecom has taken this to include comparable legacy products that are being traded internally).
- 87 Telecom proposes that the following business units would produce product statements:
- Chorus; and
 - Wholesale.
- 88 Telecom notes that the key regulated services that should be reported on for accounting separation requirements should be:

| |
|--|
| Chorus: |
| UCLL and co-lo – urban (including legacy services) |
| UCLL and co-lo – non-urban (including legacy services) |
| UCLL Backhaul (including legacy services) |
| Sub-loop (delayed) |
| Wholesale: |
| UBA (including EUBA and legacy services) |
| UBA Backhaul (including legacy services) |

- 89 Unbundled Copper Local Loop (UCLL) and co-location (co-lo) should be reported together as there is a commonality of assets at the exchange, and one cannot practically be purchased without the other. Individual line items within the product statements would split out the UCLL from the co-location components.
- 90 Telecom also proposes that the sub-loop statement be delayed until at least the 2011 financial year. This is partly because the sub-loop standard terms determination (STD) does not yet exist, making it difficult to assess what will be required. Also, given current expectations of low external volumes in the

²² See page 6 (e) of the Commerce Commission’s *Draft Notification of Information Disclosure Requirements on Telecom New Zealand under Part 2B of the Telecommunications Act*.

2009 and 2010 years, the preparation of a separate statement would be of little value. Telecom proposes for the first year to report the revenue figures for internal and external sub-loop metallic path facility (MPF), co-lo, plus backhaul as part of the UCLL statement, but the costs of these services will not be split from the UCLL costs. If the reported revenues show that this has become a significant service then a separate statement could be considered, but Telecom anticipates that this is unlikely.

- 91 The Draft Principles Paper proposed including the service of interconnection with Telecom's fixed PSTN in the list of services requiring product statements. This service is a legacy product with a commercially agreed price. Despite all interconnected parties having had the option for some time now of applying to the Commission for a STD in relation to this service, no party has considered this necessary. This suggests the commercial arrangements in place are effective and efficient, and there is no clear need for a product statement (noting that if such a need became apparent, it would be open to the Commission to require this at that time). 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.

APPENDIX A: Telecom's Proposed Reporting Milestones

Telecom proposes the following transitional and reporting milestones for the year ending 30 June 2009.

| Date | Milestone |
|-------------------------|--|
| 14 November 2008 | The Commission to confirm to Telecom: <ul style="list-style-type: none"> • The use of the ABM model to allocate opex costs; • Asset valuation methodology to be used; • Pre tax and post tax WACC rate to be used; • The purpose and form of each service group; • The form / presentation of the regulatory financial statements; and • The matters to be discussed at each of the monthly update meetings. |
| 21 November 2008 | Advise Commission in writing of financial systems, processes and input data sources available for preparing regulatory accounts. |
| 1 December 2008 | The Commission to confirm to Telecom: <ul style="list-style-type: none"> • Complete list of regulated products to be reported in 2009/10; • Agreement of list of audit tender candidates; • The audit process and scope; • The form of audit opinion ("prepared in accordance with" or "fairly presents") • The materiality threshold. |
| 19 December 2008 | Issue tender for regulatory audit work, which includes a detailed audit scope. Preliminary Accounting Policy Manual, Attribution Methodologies Manual and Asset Valuation Manual. Preliminary details to be at process level. |
| 28 February 2009 | Auditor formally engaged. |
| 31 March 2009 | Opening Statement of Assets controlled by Wholesale presented to the Commission. |
| 30 June 2009 | Accounting Policy Manual, Attribution Methodologies Manual and Asset Valuation Manual completed. |
| 30 September 2009 | Audit opinions on Manuals provided to the Commission |
| 15 December 2009 | Under a transitional 'prepared in accordance with' audit opinion - Draft regulatory financial statements provided to the Commission. |
| 31 December 2009 | Under a transitional 'prepared in accordance with' audit opinion - Regulatory financial statements publicly disclosed |

| | |
|-------------------------|--|
| | - Auditor provides audit opinion to the Commission |
| 15 February 2010 | Under a 'fairly presents' audit opinion - Draft regulatory financial statements provided to the Commission. |
| 27 February 2010 | Under a 'fairly presents' audit opinion - Regulatory financial statements publicly disclosed - Auditor provides audit opinion to the Commission |

Telecom proposes the following reporting milestones for the year ending 30 June 2010.

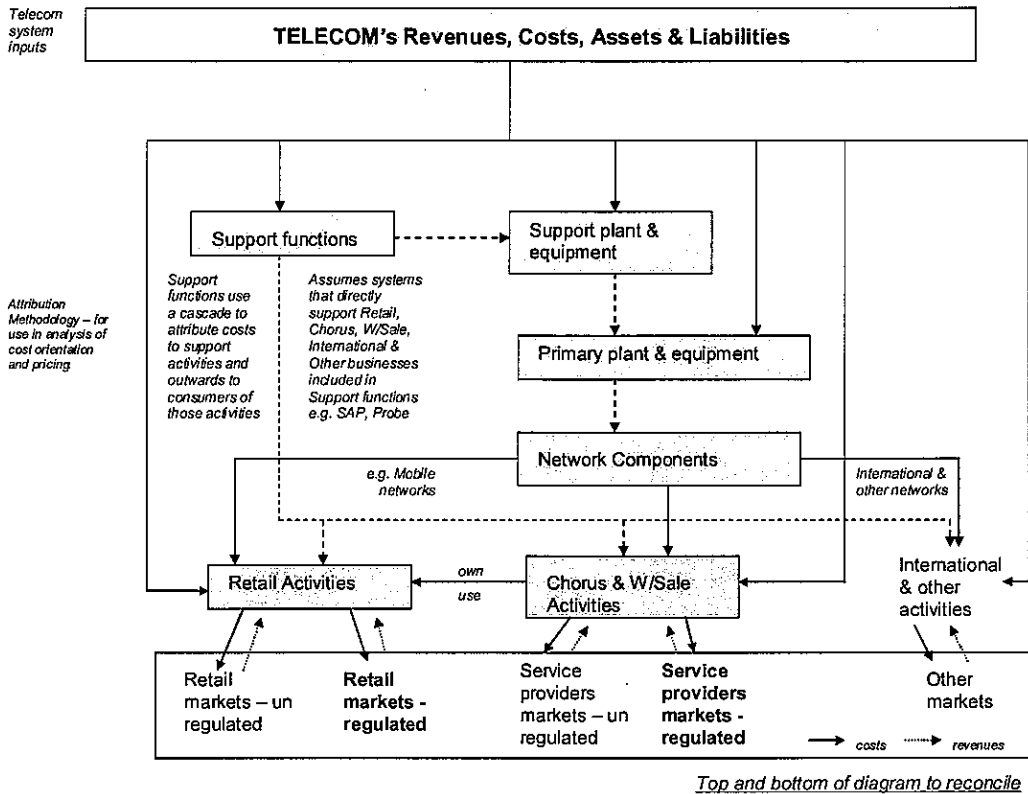
| Date | Milestone |
|-------------------------|--|
| 31 March 2010 | Revised Accounting Policy Manual, Attribution Methodologies Manual and Asset Valuation Manual. |
| 30 June 2010 | Audit opinion on change process and manuals provided to the Commission. |
| 15 December 2010 | Draft regulatory statements provided to the Commission. |
| 31 December 2010 | Under a 'fairly presents' audit opinion - Regulatory financial statements publicly disclosed - Auditor provides audit opinion to the Commission |

APPENDIX B: Telecom's Proposed Reporting Requirements

Telecom proposes the following regulatory reporting requirements.

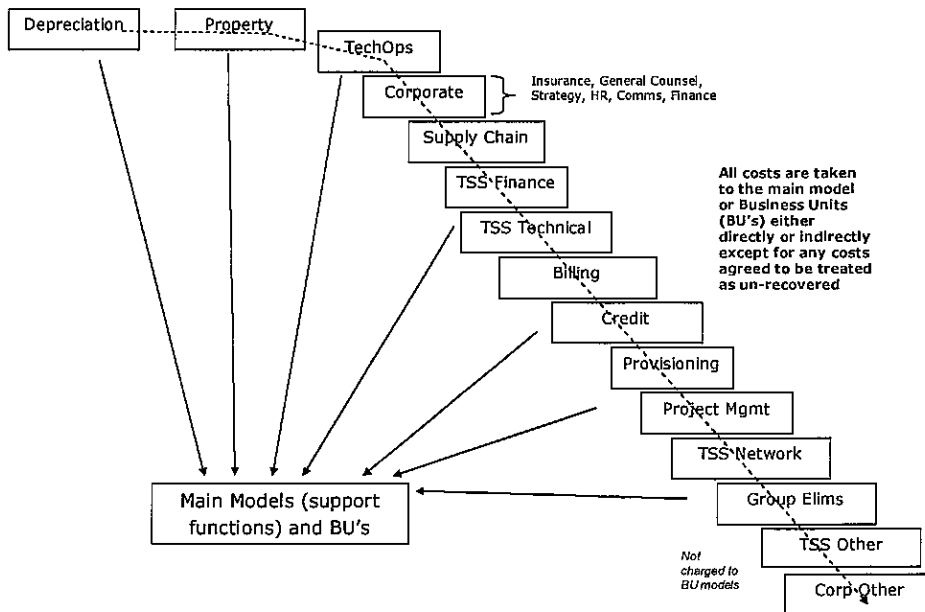
| | 2008/09 | | 2009/10 | |
|--|---------|-----|---------|-----|
| | HCA | ECA | HCA | ECA |
| <u>Regulatory Financial Statements</u> | | | | |
| Regulated Consolidated Statement of Financial Performance | ✓ | ✓ | ✓ | ✓ |
| Regulated Consolidated Statement of Mean Capital Employed | ✓ | ✓ | ✓ | ✓ |
| Regulated Consolidated Statement of Financial Performance for each Service Group | ✓ | ✓ | ✓ | ✓ |
| Regulated Consolidated Statement of Mean Capital Employed for each Service Group | ✓ | ✓ | ✓ | ✓ |
| Reconciliation of Consolidated Statement of Financial Performance | ✓ | ✓ | ✓ | ✓ |
| Reconciliation of Mean Capital Employed Statement | ✓ | ✓ | ✓ | ✓ |
| Regulatory Statement of Assets for Access Services | ✓ | ✓ | ✓ | ✓ |
| Regulatory Statement of Assets for Wholesale Services | ✓ | ✓ | ✓ | ✓ |
| Product Statements for specified products | | | | ✓ |
| | | | | |
| <u>Compliance Monitoring requests</u> | X | X | X | X |
| | | | | |

APPENDIX C: Telecom's Proposed Attribution Methodology



A summary diagram of the dynamic cascade mentioned above is represented below.

ABM Cascade



APPENDIX D: Telecom's Proforma Financial Statements**Service Group****Regulatory Financial Performance Statement**

for the year ended 30 June 20xx

| YEAR ENDED 30 JUNE (DOLLARS IN MILLIONS) | 20XX \$ | 20YY \$ |
|--|------------|------------|
| Operating Revenue | | |
| External sales | x | x |
| Internal sales to Wholesale | x | x |
| Internal sales to Retail | x | x |
| Internal sales to Other | x | x |
| Total operating revenues | x | x |
| Operating Expenses | | |
| Labour | x | x |
| Intercarrier expenses | x | x |
| Other operating expenses | x | x |
| Depreciation and amortisation | x | x |
| Other expenses | x | x |
| Internal expenses from Wholesale | x | x |
| Internal expenses from T&SS | x | x |
| Internal expenses from Corporate | x | x |
| Total operating expenses | x | x |
| Earnings / (loss) before interest and taxation (EBIT) | x | x |
| Net assets (historic cost) | x | x |
| Forward looking EBIT | x | x |
| Forward looking net assets | x | x |

Service Group**Regulatory Statement of Capital Employed**

for the year ended 30 June 20xx

| YEAR ENDED 30 JUNE (DOLLARS IN MILLIONS) | 20XX \$ | 20YY \$ |
|---|------------|------------|
| Current assets | | |
| Cash and short term investments | x | x |
| Receivables and prepayments | x | x |
| Inventories | x | x |
| Total current assets | x | x |
| Current liabilities | | |
| Accounts payable and accruals | x | x |
| Short-term provisions | x | x |
| Other short term provisions and liabilities | x | x |
| Total current liabilities | x | x |
| Net current assets | x | x |
| Non-current assets | | |
| Receivables due after one year | x | x |
| Long-term investments | x | x |
| Intangible assets | x | x |
| Property, plant and equipment | x | x |
| Total non-current assets | x | x |
| Non-current liabilities | | |
| Long-term liabilities | x | x |
| Long-term provisions | x | x |
| Total non-current liabilities | x | x |
| Net Assets (historic cost) | x | x |
| Forward looking net assets | x | x |

Reconciliation of Regulatory Financial Performance Statement

for the year ended 30 June 20xx

| YEAR ENDED 30 JUNE (DOLLARS IN MILLIONS) | for the year ended 30 June 20xx | | | for the year ended 30 June 20xx | | |
|---|---------------------------------|--------------------|---|---------------------------------|--------------------|---|
| | Operating Revenues | Operating expenses | Earnings/ (loss) before interest and taxation | Operating Revenues | Operating expenses | Earnings/ (loss) before interest and taxation |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| EBIT per separated accounts | | | | | | |
| Chorus | x | x | x | x | x | x |
| Wholesale | x | x | x | x | x | x |
| Retail | x | x | x | x | x | x |
| Corporate and other | x | x | x | x | x | x |
| Total EBIT per separated accounts | x | x | x | x | x | x |
| Adjustments | | | | | | |
| Intra company transfers | x | x | x | x | x | x |
| Other adjustments | x | x | x | x | x | x |
| EBIT per Telecom Statutory Accounts | x | x | x | x | x | x |

Reconciliation of Regulatory Statement of Capital Employed

for the year ended 30 June 20xx

| YEAR ENDED 30 JUNE (DOLLARS IN MILLIONS) | 20XX \$ | 20XX \$ |
|--|------------|------------|
| Net Assets per Separated Accounts | | |
| Chorus | x | x |
| Wholesale | x | x |
| Retail | x | x |
| Corporate and Other | x | x |
| Total net assets per separated accounts | x | x |
| Per Telecom Statutory Accounts | | |
| Total assets | x | x |
| Total liabilities | x | x |
| Adjustments: | x | x |
| Taxation recoverable | | |
| Taxation payable | x | x |
| Dividends payable | x | x |
| Debt due within one year | x | x |
| Deferred taxation | x | x |
| Long term debt | x | x |
| Other items | x | x |
| Total net assets per Telecom Statutory Accounts | x | x |