

GOVERNMENT & INDUSTRY RELATIONS

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Douglas Webb
Telecommunications Commissioner
Commerce Commission
PO Box 2351
WELLINGTON

Dear Commissioner Webb

Please find attached a paper on interconnection pricing by Charles River Associates. This report, coupled with this letter, is Telecom's submission on the Commerce Commission's paper by Frontier Economics entitled "Interconnection Pricing Methodology".

The substance of Telecom's submission is contained in the CRA paper. This letter provides an added commentary on aspects of local interconnect pricing in New Zealand. Both CRA and Frontier propose TSLRIC pricing for toll bypass and mobile to fixed interconnection, and in the context of the Act Telecom supports those conclusions.

Pure Bill and Keep or Hybrid Bill and Keep for local interconnection

Telecom is comfortable with the conclusions reached by Frontier Economics on local interconnection. We believe the recommended interconnect pricing methodologies reflect a good balance of practicality and dynamic efficiency and they are consistent with well-established international approaches to interconnect. The Frontier Economics conclusions also support existing commercially negotiated approaches to interconnect in New Zealand. That is, pure bill and keep for defined call sink traffic (primarily internet) and a hybrid bill and keep approach for non-call sink traffic. Absent any strong rationale for moving away from commercially negotiated outcomes, we believe the Commission should give weight to such market-based arrangements. On this basis, we have put forward in our application to the Commission on interconnection a mix of pure and hybrid bill and keep.

Having said this, the attached CRA paper concludes that pure bill and keep for all local traffic is the optimal outcome. As part of the process of preparing this submission in the last two weeks, and as a result of CRA's independent advice, we have strengthened our view that pure bill and keep is the preferable option for all local traffic.

Of these two conclusions (either Frontier Economics or CRA) Telecom believes the CRA approach is the most robust on the basis of dynamic efficiency, simplicity and avoidance of arbitrage risk (as hybrid bill and keep retains a known risk of arbitrage not present with pure bill and keep). However, it is Telecom's view that the Commission should give weight to commercially negotiated solutions. We would not, therefore, be uncomfortable with the (second best) Frontier Economics conclusion.

The Commission should give considerable weight to the risks of arbitrage and the value of simplicity. The definition of what constitutes a call sink and the subsequent measurement of this traffic is a complexity which should not be underestimated. The measurement of call sink traffic is significantly more simple than attempting to differentiate between voice and data. Telecom has done this in the past on the basis of identifying that certain numbers are used primarily for terminating internet traffic. Such an approach requires significant monitoring and is open to arbitrage. If a mix of pure and hybrid bill and keep is to be used, our strong preference is for a call sink/non-call sink distinction to be used. Pure bill and keep significantly simplifies all these issues.

Telecom's experience in implementing its call sink approach to interconnect is instructive on the risks of arbitrage. For example, very soon after signing the Clear agreement in October 2000 with a hybrid bill and keep solution coupled with a call sink provision, another carrier commenced an arbitrage initiative to keep traffic within the 10:1 ratio that defined a call sink. This traffic would then attract termination charges. The arbitrage initiative involved terminating internet traffic that originated from the Telecom network, but using a computer call generator to send "phantom" return calls purportedly from the same number used to terminate the authentic internet traffic. The result was an appearance of traffic within the 10:1 ratio of incoming to outgoing traffic and hence Telecom was expected to pay termination payments.

Differentiated approach supported

We strongly endorse Frontier Economics' approach to assessing different types of interconnect traffic separately, and asking which interconnect arrangements will best be in the long-term interests of end-users. This underlying principle was clearly envisaged by Parliament in Part 1 Subpart 1 Section 4 of Schedule 1 where the Act empowers the Commission to "choose different pricing principles for different call types of voice and data calls (including dial-up internet data calls) or calls with different characteristics for designated interconnection access services".

Parliament recognised that a "one size fits all" approach whereby the same interconnect pricing methodology applied to all types of traffic would be unlikely to meet the purpose of the Act.

In particular, the reference to potentially treating voice and data calls differently and with a further specific reference to "dial-up internet data calls" also clearly supports a view that data and in particular internet data calls should be treated differently in terms of interconnect arrangements.

"Additional Matters" are important

Telecom also places emphasis on the additional matters that must be considered by the Commission regarding the application of Section 18. These are spelt out in Schedule 1 dealing with both interconnection with Telecom's fixed PSTN and other fixed PSTNs.

This part of the Act lists the following additional matters:

- (a) incentives to terminate dial-up internet traffic and other similar one-way traffic streams must be efficient; and
- (b) the effect of any obligation under the TSO instrument to provide price-capped unlimited calls.

This is the only designated service where additional matters to be considered are specifically listed. Clearly Parliament attached particular weight to these two factors when stating they must be considered.

Additional Matter (a) is a clear signpost to the Commission that Parliament was aware that internet traffic in particular introduced its own specific set of issues and regulatory risks. The well-documented issues to do with free ISPs and incentives to generate internet traffic to attract interconnect termination payments are of course widely understood. Frontier Economics is therefore correct in examining the potential asymmetry of regulatory risk when assessing optimal interconnect arrangements for internet traffic. Frontier Economics' conclusion that bill and keep offers the best approach to data traffic because of the significant risks involved with using TSLRIC for data interconnect is supported by the Act's inclusion of Additional Matter (a).

Additional Matter (b), which focuses on the effect of free local calls under the TSO, is a closely related issue. Clearly Parliament was aware that optimal interconnect arrangements without the existence of the TSO may not be the optimal arrangements given the existence of the TSO. Telecom has put forward to the Commission previously its view that free local data calling represents an inefficient arrangement with potentially damaging long-term consequences for end-users. In simple terms, free local internet calling provides a subsidy for dial-up internet users. Telecom has no or limited ability to pass on termination charges for internet traffic to its local access residential customers. The effect of using TSLRIC for internet traffic would therefore likely be to increase the level of subsidy provided to dial-up internet users. The ability of the market to pass through to internet users the price signal ISPs received from interconnect payments has been demonstrated by the rapid appearance of free ISPs and their subsequent disappearance once interconnect agreements were renegotiated.

We strongly support Frontier Economics' conclusion that some of the negative effects of the TSO can be mitigated by bill and keep. Networks competing for ISPs' business will reflect into the charges to ISPs the costs of providing terminating lines and the switching and transport costs associated with terminating incoming local calls. These prices will be passed through to retail internet users.

Parliament clearly considered the TSO instrument is relevant to the Commission's choice of interconnect methodology. Frontier Economics is correct in approaching the question of interconnect methodology choice by looking at ways in which dynamic efficiency can be maximised given the existence of the TSO. We would concur that pure bill and keep for at least data traffic is the optimal solution given the existence of the TSO.

Overseas experience supports Bill and Keep

This position is borne out by overseas experience, particularly in the US. Unlimited local internet calling is not common. The US, Canada and New Zealand are the only OECD countries where this is widespread. All these countries are either moving to, or have implemented, bill and keep for internet traffic. This overseas experience would support the Commission adopting bill and keep for at least internet or call sink traffic.

The CRA submission stresses the importance of managing the risk of regulatory arbitrage. The experience internationally as well as in New Zealand is that companies will seek out opportunities to arbitrage interconnect arrangements, and this can lead to unintended consequences that are impossible to predict.

Pure bill and keep for both local data and local voice offers at this point in time the best protections against arbitrage opportunities. The Commission should be mindful that this may not always be the case. Managing the risks of regulatory arbitrage should be an important criteria for the Commission in selecting appropriate interconnect methodologies. This leads Telecom to support pure bill and keep for all local interconnect traffic.

One other aspect of the TSO which has implications for selection of optimal interconnect methodologies is the impact on the size of the TSO loss. Frontier Economics is correct in stating that termination payments for internet traffic would lead to an increase in the TSO loss. A result of this would therefore not only be an increase in the effective subsidy provided to dial-up internet users but additional TSO loss costs flowing through to other telecommunications users such as mobile and long-distance customers.

I look forward to participating in the Commerce Commission's conference on interconnect issues later this year.

Yours sincerely

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Government & Industry Relations