



TelstraClear Limited

Review of Designated and Specified Services under the  
Telecommunications Act 2001: Proposals for Amendments to  
Services Commission has Decided to Investigate

21 December 2005

## 1 INTRODUCTION

1. The Commission has invited proposals for amendments to the ten regulated services it has decided to investigate.<sup>1</sup> In this submission, TelstraClear proposes amendments to the service called “Residential Local access and Calling Service Offered by means of Telecom’s Fixed Telecommunications Network” (the “price-capped residential local access services”).
2. TelstraClear proposes that the initial and final pricing principles should conform to those which apply to non-price capped resale services. Specific wording for these proposed amendments is provided in Section 2 below.
3. TelstraClear considers that these amendments would assist in ensuring that the Telecommunications Act 2001 (the “Act”) achieves its purpose, as set out in section 18(1), of promoting competition in telecommunications markets for the long-term benefit of end-users of telecommunications services. The proposed amendments will enhance competition in New Zealand telecommunications markets by ensuring that resale can be undertaken profitably by an efficient reseller.

## 2 PROPOSED AMENDMENTS

4. TelstraClear proposes the following amendments to the pricing principles applicable to the price-capped residential local access services:

*Initial pricing principle:* Either-

- (a) retail price less a discount benchmarked against discounts in comparable countries that apply retail price minus avoided costs saved pricing in respect of residential local access and calling services, in the case of a service offered by Telecom in markets in which Telecom faces limited, or is likely to face lessened, competition for that service; or
- (b) retail price less a discount benchmarked against discounts in comparable countries that apply retail price minus actual costs saved pricing in respect of residential local access and calling services, in the case of a service offered by Telecom in markets in which Telecom does not face limited, or lessened, competition for that service.

*Final pricing principle:* Either-

- (a) average or best retail price minus a discount comprising avoided costs saved pricing, in the case of residential local access and calling services offered by Telecom in markets in which Telecom faces limited, or is likely to face lessened, competition for that service; or

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<sup>1</sup> Paragraph 40, Commerce Commission, *Review of Designated and Specified Services under the Telecommunications Act 2001: Decision to Investigate*

- (b) average or best retail price minus a discount comprising actual costs saved, in the case of residential local access and calling services offered by Telecom in markets in which Telecom does not face limited, or lessened, competition for that service.

### 3 EXPLANATION FOR WHY AMENDMENTS ARE REQUIRED

#### 3.1.1 *TelstraClear has previously identified concerns that actual costs saved standard for price-capped services is inconsistent with s.18*

- 5. TelstraClear has previously noted its concerns about the actual costs saved discount in relation to the current wholesale and residential resale pricing reviews.<sup>2</sup> As noted in TelstraClear's submission on application of the final pricing principle, the Ordover/Klick report that accompanied the submission concluded that the application of the actual costs saved standard in non-competitive markets is economically unsound:<sup>3</sup>

*"We are aware that this treatment is mandated by the 2001 Act, and it is not our purpose here to seek to resolve this issue. However, within these limitations we suggest that the Commission should consider whether a change in this principle is warranted and, at a minimum, should consider the extent to which "actual costs saved" for price-capped, non-competitive residential service might include categories and/or allocations of cost that it would not anticipate reflecting for services that face effective competition..... Because there are limited prospects for deployment of residential networks in New Zealand, resale of residential local telephony services is likely to be the main means of competition – and these services, by value and volume, are likely to become one of the most significant resale categories."*

- 6. TelstraClear recommended that the Commission should undertake a Schedule 3 inquiry into whether the Commission should recommend to the Minister a change in the final pricing principle for price-capped residential local access services.<sup>4</sup> However, given that the Commission is in the process of reviewing this service, now is an appropriate time to consider whether the initial and final pricing principles for price-capped residential local access services should be amended.

#### 3.1.2 *Actual costs saved standard is inappropriate because price cap does not prevent Telecom earning monopoly profits*

- 7. The policy reasoning that appears to lie behind the decision to use the actual costs saved standard as the final pricing principle for price-capped residential local access services, and by implication, a discount of 2% for the initial pricing principle, is flawed. Like the services for which the avoided costs saved standard applies, price-capped residential local access services are non-competitive.

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<sup>2</sup> Refer TelstraClear Limited, *Submission to the Commerce Commission on Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004

<sup>3</sup> Ordover, J.A. and Klick, J.C., *Issues Raised by the Commerce Commission's 30 September 2004 Paper Entitled Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004, pages 18-19.

<sup>4</sup> Refer paragraph 27, TelstraClear Limited, *Submission to the Commerce Commission on Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004, page 15.

However, unlike these other non-competitive services, they are subject to a price cap. The reasoning behind the decision that the actual costs saved standard is the appropriate final pricing principle appears to have been that, because these services are subject to a price cap, Telecom would be constrained from fully recovering its costs if the pricing principle was avoided costs saved. This reasoning appears to be based on a view that:

- a. the price cap imposes a significant constraint on Telecom's prices;
  - b. the price cap prevents Telecom from earning monopoly profits on its access services;
  - c. if the price cap is sufficient to limit Telecom to earning only normal profits on price-capped residential local access services, applying the avoided costs saved pricing principle would result in Telecom being unable to recover its costs and, as a result, the smaller actual costs saved discount should apply.
8. As is clear from the above, the reasoning behind the decision to apply the actual costs saved standard to price-capped residential local access services hinges on the price cap being sufficient to prevent Telecom from earning monopoly profits from sale of price-capped services. However, as TelstraClear has pointed out on numerous occasions in the past, the evidence is quite the contrary: despite the price cap, Telecom is able to earn substantial monopoly profits on price-capped residential local access services.<sup>5</sup> Telecom has an "access surplus" with 1.3 million profitable residential customers but only 62,995 commercially non-viable residential customers. TelstraClear identified three main reasons why Telecom is able to obtain monopoly profits from price-capped residential local access services in its submission in relation to the 2002/03 TSO:<sup>6</sup>
- a. *The price cap is CPI-0, which allows Telecom to maintain the real price of residential services in perpetuity, even though the costs of providing telecommunications services have plummeted over the last decade, and continue to decline.*
  - b. *Telecom has shown it is able to substantially cut residential telephony rates (and still remain profitable) if it has to because of competition, ie in Wellington and Christchurch where TelstraClear has a residential network Telecom's residential prices are \$32.85 per month, compared to \$39.85 per month elsewhere.*
  - c. *Telecom has released figures which show that, under the Telecommunications Information Disclosure Regulation, Telecom considers the cost of supplying basic residential telephony services costs as little as \$11 per month compared to the standard residential price of \$39.85 per month) in some ESAs."*
9. Since Telecom earns monopoly profits from its price-capped residential local access services, the actual costs saved standard is the wrong final pricing

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<sup>5</sup> Refer Annex 5, TelstraClear Limited, *Submission on the Draft Determination for TSO Instrument for Local Residential Service for period between 1 July 2002 and 30 June 2003*, 13 August 2004, pages 92-93.

<sup>6</sup> *ibid*, paragraph 314.

principle; rather, just like the other non-competitive services from which Telecom is able to earn monopoly profits the appropriate final pricing principle is avoided costs saved. As a consequence, the initial pricing principle for price-capped residential local access services is also inappropriate and should be amended to the same as that for other non-competitive services, ie currently calculated by the Commission to be 16% from the average modal price.

3.1.3 *Actual costs saved standard is inconsistent with the efficiency objectives of providing for resale of telecommunications services*

10. Not only is the reasoning behind the decision to apply the actual costs saved standard to price-capped residential local access services flawed but the standard also fails to ensure that the efficiency objectives of providing for resale are achieved. In particular, because the lesser discount of actual costs saved applies to services from which Telecom is able to earn monopoly profits, it is likely that Telecom will over-recover its wholesaling costs. Conversely, because the reseller faces a smaller discount than for other non-competitive services, the greater the likelihood that it is unable to obtain sufficient returns to cover its costs.
11. The policy rationale for providing for resale is that it will promote efficiency by lowering the overall costs of retailing. Provided that the discount a reseller faces reflects efficient costs a reseller will only enter the market if it is more efficient than the incumbent in providing the service, in terms of total directly attributable costs; but if a reseller's costs are greater than those of the incumbent it will be prevented from entering.
12. However, for price-capped residential local access services actual costs saved would appear to introduce an inappropriate wedge between the incumbent's costs and a reseller's by failing to eliminate all the relevant costs of the incumbent and raising the costs of the reseller. As a result, even if the reseller were more efficient than the incumbent it would still be prevented from entry or, in the event that it did enter under the initial discount of 2% in the hope that the actual costs standard was revisited, it would be forced out of the market if the standard remained unchanged. As Ordover and Klick commented:<sup>7</sup>

*“Because resellers must incur their own retail costs to enter the market, failure to eliminate the full amount of the incumbent's long-run avoidable retail costs as part of the wholesale discount creates a risk that the spread between the input cost (wholesale price) and the price of the output would not allow an efficient reseller firm to compete effectively. Companies seeking to enter the market using resale – even if they are as efficient or more so than the incumbent – would be prevented from doing so because they effectively would be forced to incur both their own long-run retail costs and also defray a portion of the incumbent's avoidable (in the long-run) retail costs as a component of the wholesale rate.”*

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<sup>7</sup> Ordover, J.A. and Klick, J.C., *Issues Raised by the Commerce Commission's 30 September 2004 Paper Entitled Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004, page 7.

13. Failure to eliminate all of an incumbent's relevant retailing costs also increases the likelihood that the incumbent is also able to access anti-competitive cross subsidies. This would have a further negative impact on competition and further diminish the likelihood that the policy objectives of providing for resale would be achieved. The risk of the existence of such cross-subsidies is increased in the presence of monopoly profits. Use of a pricing principle that only partially defrays the incumbent's retail costs increases the likelihood that such cross-subsidies will be used against the entrant. Moreover, the likelihood of this occurring is increased if there are no transparency mechanisms in place to ensure that such cross-subsidies are visible, which is the case for Telecom.

*3.1.4 Costs of retailing price-capped services are no different to costs of retailing non price-capped services*

14. An alternative rationale for priced-capped residential local access services being subject to a smaller discount than non price-capped services is a view that the costs of wholesaling price-capped residential local access services are greater, or the retailing costs lower, than those for non price-capped services, either of which would imply a smaller discount. However, TelstraClear does not consider that there is any difference in the costs of wholesaling or retailing price-capped services compared with non price-capped services. The activities involved in wholesaling or retailing price-capped residential local access services, ie sales, billing, marketing, etc, are no different to those involved in wholesaling or retailing other non-competitive services and so the costs should be no different either. In Decision 497, the Commission itself decided that the same initial discount of 16% should apply between residential and business non-price capped services and TelstraClear does not believe that there is a material difference in the avoided costs in supplying price-capped and non price-capped services to residential customers.
15. As with other services, the discount should be based on the costs that Telecom would avoid in the long run if it were no longer retailing price-capped services. In other words, the discount should be based on the difference between Telecom supplying the service on a wholesale and retail basis (factual) with Telecom supplying the service on a wholesale-only basis (counterfactual). As TelstraClear has previously argued,<sup>8</sup> and the Commission has confirmed,<sup>9</sup> this is the basis that should be used for determining the discount when the pricing principle is avoided costs saved.

*3.1.5 An avoided costs saved standard for price-capped services will not result in under-recovery of Telecom's costs*

16. The objection may be raised that the avoidable costs standard is not appropriate because of the risk of under-recovery of Telecom's costs. TelstraClear considers that there is no such risk. As discussed above, the evidence is clear that Telecom earns substantial monopoly profits on its price-capped residential local access services despite (or, in fact, because of) the price

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<sup>8</sup> Paragraph 6, TelstraClear Limited, *Submission to the Commerce Commission on Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004, page 3.

<sup>9</sup> Page 1, Commerce Commission, *The Commission's View on the 'Actual Costs Saved' and 'Avoided Costs Saved' Standards: Application of the Final Pricing Principle for Resale of Telecom Retail Services*, 11 April 2005.

cap. For the small minority of customers for which Telecom makes a loss on price-capped services, Telecom's costs are met by the TSO. Telecom's retailing costs should be allocated across all its customers. Because it earns a substantial monopoly profit overall on its price-capped residential local access services, which is further topped up by the TSO payment, not only is there no risk that there would be an under-recovery of costs with the avoided costs saved standard, there is a risk of over-recovery if the discount does not also seek to eliminate monopoly rents and associated inefficiencies.

### *3.1.6 Conclusion on appropriate pricing principle for price-capped services*

17. The avoidable costs saved discount would therefore be a more appropriate final pricing principle for price-capped residential local access services than actual costs saved. The avoidable costs saved standard discount would:
  - a. be consistent with the standard used for other non-competitive services;
  - b. ensure that all Telecom's relevant retailing costs were eliminated, including monopoly profits, which would mean that efficient reseller entry would be possible;
  - c. prevent Telecom accessing anti-competitive cross-subsidies; and
  - d. thereby, better promote the Act's objective.

### *3.1.7 Baseline price for discount should be same as that for other non-competitive services*

18. In addition to the question of what is the appropriate pricing principle, there is also the issue, applicable to both the initial and the final pricing principles, of what price the discount should apply to. Effectively there are two options: the "standard" price that Telecom charges or the "average or best" price. TelstraClear's view is that this "baseline price" for price-capped residential local access services should be the same as that for all other non-competitive services, ie "average or best" retail price. This would ensure that, in the event that Telecom decided to apply a discount to its retail price for price-capped residential local access services, an efficient reseller would not face an anti-competitive price squeeze and would be able to continue to compete.

## **Recommendation**

19. TelstraClear recommends the same initial pricing principle and final pricing principle apply to price-capped residential local access services offered by means of Telecom's fixed telecommunications network as apply to non price-capped resale services.

TelstraClear