The NGC Building
44 The Terrace
Private Bag 39980
Wellington Mail Centre
Phone +64 4 462 8700
Fax +64 4 462 8600

29 October 2003

Alex Cheetham
Unbundling Draft Report
Network Access Group
Commerce Commission
Level 6, 44-52 The Terrace
WELLINGTON

Dear Alex

Telecom Local Loop Unbundling – NGC Submission on Draft Report

1. NGC welcomes the opportunity to comment on the Commerce Commission's Draft Report on unbundling the local loop network and fixed public data network.

2. NGC is an infrastructure-focussed energy services company which is listed on the New Zealand Stock exchange. Its business activities include:

   - Gas transmission and distribution;
   - Gas processing and wholesaling;
   - LPG supply; and
   - Energy metering and data administration.

3. NGC's comments are made in relation to the overall direction and framework which the Commission is applying to the telecommunications industry. NGC is concerned that the proposals may have broader implications for investment in infrastructure and infrastructure-focussed companies. NGC believes the terms and conditions of access to infrastructure are best determined by commercial negotiation, so the market reality for participants taking risks is appropriately reflected in the arrangements.

4. There are two broad areas of concern about the Draft Report:

   - The extent of regulatory intervention; and
   - The cost benefit analysis used to support the conclusions.

Extent of Regulatory Intervention

5. In NGC's view the potential impacts on dynamic efficiency and long-term consumer benefit of over regulation caution against more than the minimum intervention that is necessary for competition to emerge. In the telecommunications industry a number of new players such as Walker Wireless and Team Talk appear prepared to invest to compete with Telecom. This outcome under current market conditions suggests that regulatory intervention should be kept to a minimum to limit the disincentives for innovation and investment.

6. If the Commission is to proceed with unbundling, NGC believes only the raw copper lines should be subject to regulation. It appears that the proposed unbundling of the public data network (PDN) goes far beyond simply giving access to competitors to Telecom's basic copper network. The PDN involves the value-add investment Telecom puts on top of its raw infrastructure including operational support systems, billing and all the equipment needed to turn the basic network infrastructure into a PDN or retail service.

7. A competitor who lacks either the resources or the commitment to invest in the value-add infrastructure to utilise the lines may not provide sustainable competition and thereby long-term consumer benefit. In this regard, the concept of a hypothetical new entrant investing in the necessary infrastructure is useful. If a new entrant could make this investment profitably they would not need regulated access to more than the raw lines. If the investment can not be made profitably, then regulated access to more than the lines would be unlikely to deliver lower prices on a sustainable basis.

8. NGC notes that the Commission's definition of a PDN involves not just existing retail services that Telecom has already built, but ones that it is either in the process of building or has not even built yet. These include IP networks and Telecom's Next Generation Network. The precedent that a company's investment in a new capability or functionality should be immediately regulated to provide competitors with access is likely to have an impact on the incentives to invest and innovate that is wider than the telecommunications sector. NGC believes this approach sends a negative signal to infrastructure investors which may lead to significant dynamic efficiency losses.

Cost Benefit Analysis

9. NGC is concerned that the Commission apply a robust framework which captures all the costs and benefits from a regulatory intervention such as unbundling the local loop. In particular, NGC believes care should be exercised in relation to the benefits attributable to this intervention, the realisation of consumer benefits, and the representation of efficiency gains.

10. It is not clear to NGC whether or not the cost benefit analysis has allowed for the effects of the Commission's Wholesale Determinations in respect of Telecom. The benefits estimated for this unbundling intervention should be net of those attributed to other interventions, such as the Wholesale Determination, as they would feature in both the factual and the counterfactual.

11. It appears that most of the benefits are assumed to be passed through to the consumer rather than be captured by the competitors who access Telecom's facilities. The robustness of this assumption should be tested carefully. NGC notes that the Commission itself raised concerns with the Government in relation to the potential for electricity retailers to capture the benefits of any price reductions by electricity lines businesses.

12. The Commission's consultant, OXERA, does not attempt to explicitly model efficiency gains, but claims its price effects model represents a mix of allocative, productive, and dynamic efficiency gains. NGC finds this claim surprising as it would expect the imposition of a more

intrusive regulatory regime to result in productive efficiency losses of 1-3%[1]. In an industry where the operating costs are in the billions of dollars, such productive efficiency losses are significant in relation to OXERA's estimate of benefits.

13. Similarly, OXERA's analysis does not appear to include any dynamic efficiency losses resulting from delayed or lower-specification investment by either Telecom or alternate network builders in response to the incentives created by the proposed regulation of new capability or functionality. NGC suggests that these losses may be a very significant factor for the Commission to take into account, particularly where competitors gain access to more than the basic copper network.

14. NGC notes the Commission's estimate of the benefits of unbundling is a relatively small proportion of the annual industry revenue which is in the billions of dollars. If the Commission's analysis fails to incorporate productive and dynamic efficiency losses from unbundling, then there is a risk that it will promote shorter term benefits (if any) that may largely benefit competitors but none of the significant long-term efficiency costs that will impact consumers.

Conclusions

15. Overall, NGC is concerned that the Commission's Draft Report sends worrying signals to other infrastructure industries. NGC suggests the Commission should assess carefully the extent and costs of its options for intervention, particularly the potential for significant dynamic and productive efficiency losses.

16. NGC does not wish to appear at the Commission's conference.

17. NGC would be happy to answer any questions the Commission or its staff have in relation to this submission. Please contact me in the first instance (462-8777 or 027 292 0050).

Yours sincerely

Dr Paul Hodgson
Manager Regulatory Affairs

[1] Charles Rivers Associates, *Response to Gas Control Inquiry Draft Framework Paper*, pp 47-48.