Telecom

CONFERENCE ON SECTION 64 AND SCHEDULE 3 INVESTIGATIONS

TELECOM'S CLOSING SUBMISSIONS

14 NOVEMBER 2003

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Introduction

Telecom will concentrate on five points in these submissions.

A The decision-making framework

The Commission is required to make the recommendation in relation to unbundling that will best promote competition in telecommunications markets for the long-term benefit of end-users. In doing so, the Commission must quantify costs and benefits to the extent possible and the burden of proof falls on the proponents of unbundling. Unless the Commission is satisfied that the burden of proof has been discharged and the case made out for unbundling, it must not recommend it.

B No evidence on which to recommend unbundling

Telecom submits that no probative quantitative or qualitative analysis has been presented to make the case for unbundling. The OXERA CBA is conceptually flawed and its implementation so fundamentally unreliable that it does not discharge the burden of proof required of it. Corrections to these defects would require a substantial re-write. Any attempt to do that would be inconsistent with the process in Schedule 3 of the Act.

Overseas experience gives no clear guidance to the consequences of unbundling that may be relied on by the Commission. The Australian experience, as explained by Telstra during the Conference, suggests that no significant benefits have been experienced in the 4 years since Australia was in a corresponding position to the present investigation, and that benefits ascribed to unbundling there are in fact the consequence of other regulatory intervention.

C Access competition in New Zealand

In the absence of unbundling, 80-85% of New Zealanders will have a choice of network providers for high speed telecommunications services within the next few years. There will be no significant competition problem in that period, especially in the business access sector which is the only place that the proponents of unbundling expect it to bring about any significant change.

D The risks of unbundling

The immediate consequence of unbundling will be to cast a pall over the developing wholesale market and thus stop the development of Telecom's proposed partial private circuit products as well as IP interconnection, amongst others.

Unbundling will deter investment by the potential competing infrastructure providers. It will also deter Telecom from investing in a mass-market NGN which would provide high speed multi-service access for all New Zealanders who wished to purchase it.

Even PROBE will be jeopardised.

E Unbundling is not a now or never decision

Unbundling is not a "now or never" decision and should be deferred. During any period before a reconsideration, the Commission would exercise considerable indirect oversight of invigorated wholesaling of access services, including Telecom's partial private circuit offering, and could observe whether new access technologies continued on their promised development trajectory.

A The decision-making framework

Key points:

- The issue for the Commission is whether unbundling would "*promote competition* in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand".
- The burden of proof for establishing the desirability of unbundling rests on its proponents and a high standard of proof (at any rate, no less than the civil standard) is required. That is, it must be clearly shown that there will be a competition problem in the medium to long term and that unbundling will both address this problem and deliver a net benefit.
- In determining this issue, it is not only appropriate for the Commission to conduct a quantitative CBA, the Commission is required to do so by law.
- As a matter of law, wealth transfers should be treated as welfare neutral under the Telecommunications Act.
- The appropriate market definition is a single product market for high-speed packet based access for the provision of various telecommunications applications (including voice, video, internet gaming, data etc).

Introduction

1. In this part of Telecom's closing address I would like to make a number of remarks about the decision-making framework which the Commission must work within. These issues are all covered in more detail in our written submissions and I give cross-references in the footnotes.

The promotion of competition[1]

2. Let me begin by referring back to the words of the Telecommunications Act. In making decisions under either a section 64 or a Schedule 3 investigation, the Commission is required by section 19(c) of the Act to make the recommendation in relation to unbundling that will best give effect to the purpose set out in section 18.

3. Section 18 in turn requires the Commission to make the recommendation which will best "promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services" and to consider "the efficiencies that will result, or will be likely to result" from its recommendation.

4. In Telecom's view, the references to "long-term" benefits, "competition" and "efficiencies" distinguish this inquiry from a price-control inquiry, which it has sometimes felt like over the last week.

5. Telecom and the other infrastructure investors at this Conference have presented a view of the future which is characterised by investment, innovation and genuine infrastructure competition. Telecom submits that this is the real path to benefits for the end-users of

[1] See section 1.2D, Telecom's submission dated 29 October 2003; and section C of Telecom's Supplementary Legal Submission dated 12 November 2003.

telecommunications services. Without unbundling, New Zealand will have the benefits which come from infrastructure competition: product differentiation, innovation and productive efficiencies through competitive pressures. Telecom submits that the mobile market in New Zealand bears witness to this. It also reflects the Commission's own views in its Guide to the Telecommunications Act (paragraphs 68 and 113):

> Where there are tensions between short-term allocative efficiency and long-term dynamic efficiency, the Commission takes the view that the latter will generally better promote competition for the long-term benefit of end-users.

6. I would also like to refer to two statements from the Minister of Communications in relation to the bill:

> "The measures in this bill are not light-handed or heavy-handed, they are even-handed…It is a fine balance between commercial imperative in the first instance, and Government intervention when the need arises." Hon. Paul Swain (Minister of Communications), Hansard 9 May 2001 (First Reading).
>
> "In a highly competitive market like [telecommunications] we need as much market as possible, as much government as necessary. … [The regime] is designed to promote investment in, and competition in such a way that people decide to invest in, telecommunications in New Zealand, not because of regulation, but because of return on capital." Hon. Paul Swain (Minister of Communications), Ministerial Statement, 20 December 2001.

7. Other than by excluding competitive ESAs from unbundling, I would submit that the Draft Report is not true to the spirit or the word of the Act. If it is carried through to the Final Report and accepted by the Minister, New Zealand will be consigned to an environment where regulation begets more regulation and the technologies you have heard about in the last week will not be given the chance to prove themselves.

Burden of proof[2]

8. It is also appropriate to say something early on about burden of proof and standard of proof.

9. The Commission's decisions under section 64 and schedule 3 require it be satisfied that the case for unbundling is made out to **at least** the civil standard of proof which applies in relation to clearance and authorisation applications under the Commerce Act.

10. In other words, in order for the Commission to make a recommendation in favour of unbundling, there must be (at least) clear evidence which satisfies the Commission, on (at least) the balance of probabilities that:

    (a) there will be a competition problem in the medium to long term;

    (b) unbundling will promote competition to solve this problem; and

    (c) unbundling will produce a net benefit taking into account the full range of costs and benefits.

11. An important part of the proving process is the conducting of a cost benefit analysis.

[2] See section 1.2B, Telecom's submission dated 29 October 2003; and section A of Telecom's Supplementary Legal Submission dated 12 November 2003.

The use of a CBA[3]

12. In determining whether unbundling would "promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services" it is entirely appropriate to conduct a CBA. Indeed, the Commission is required by law to "attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment"[4].

13. Professor Hausman commended the use of CBAs and suggested that the ACCC and the FCC should follow the New Zealand approach.

14. However, as I will discuss shortly, although the Commission was correct to conduct a CBA, the one which OXERA has produced does not provide any cogent evidence in favour of unbundling.

Wealth transfers[5]

15. A related issue is that of the treatment of wealth transfers. This is covered in some detail in our written submissions, but Commissioner Rebstock's comparison with a price control inquiry under section 52 of the Commerce Act means that a couple of comments are necessary in response.

16. On examination, the wording in section 52 is quite different from that under the Telecommunications Act.

- Section 52 requires the Commission to look at "the interests of persons acquiring the goods or services".
- By contrast, section 18 of the Telecommunications Act directs the Commission to look at "competition", "long-term" benefits and "efficiencies".
- The real similarity is not, as Commissioner Rebstock seemed to suggest yesterday, between section 18 and section 52, rather it is between section 18 and sections 1A and 3A of the Commerce Act which apply to authorisation applications under sections 58 and 61 (restrictive trade practices) or section 67 (mergers and acquisitions):

> **1A. Purpose—**
>
> The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand.
>
> **3A Commission to consider efficiency—**
>
> Where the Commission is required under this Act to determine whether or not, or the extent to which, conduct will result, or will be likely to result, in a benefit to the public, the Commission shall have regard to any efficiencies that the Commission considers will result, or will be likely to result, from that conduct.

- The Commission, in the Airports Report explained that section 1A is a "net economic benefit test", *not a consumer welfare test*:

[3] See section A of Telecom's Supplementary Legal Submission dated 12 November 2003.
[4] *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429, 447 (per Richardson J).
[5] See section 5.1, Telecom's submission dated 29 October 2003.

14.6. Under the recent amendment to the Commerce Act, the long title of the Commerce Act was changed so that its purpose now "is to promote competition in markets for the long-term benefit of consumers within New Zealand". The issue is whether this has led to a fundamental change in the purpose of the Commerce Act. On a first sighting, the new emphasis on consumers might be interpreted to require an approach akin to that used in chapter 13, where only the interests of acquirers (the direct or indirect consumers of the services of airfield activities) have to be considered. However, the use of the term "long-term benefit" would appear to imply a broader focus. In the long-term, New Zealand consumers in general will benefit from the continuous improvements in the allocation of resources, and the nature of products and production processes which is encouraged by the competitive process. Market supply is important. Measures that may benefit consumers in the short-term—such as price cuts—may ultimately be harmful if they unduly suppress dynamic efficiency, thereby reducing benefits in the future. On this view, the new wording in the purpose statement does no more than make explicit what was already implicit—that all production ultimately benefits consumers and that Zealand consumers will benefit most when production is efficient.

- I would urge the Commission and its staff to carefully consider our written submissions on this issue. And, if there is any legal uncertainty, Telecom submits that the presumption against interference with private property rights means that the value of Telecom's revenue being expropriated must be included in the CBA.

17. Reference was made yesterday to the legal advice on which the Commission had based its approach to this part of the investigation. It was not clear whether this legal advice is reflected in the analysis of the legislation contained in the Draft Report. If it is not, and the Draft Report does not contain the full rationale for the Commission's approach to its draft unbundling decision, then Telecom submits that the Draft Report is incomplete without that legal advice, which should have been provided to the participants to permit submissions to have been made on it.

Market definition[6]

18. Finally, in relation to market definition I repeat Telecom's submission that:

- There will be continuing convergence of the assets used to provide data and voice services such that in the near future (and certainly within 5 years) DSL, TDM, fibre, fixed wireless, mobile wireless and satellite will all offer high speed access over IP protocol.

- Very soon the present dichotomies between voice and data, and broadband and narrowband will be of historical relevance only and, instead, there will be a continuum of quality options and price constructs offered by multiple providers over different infrastructures.

- Therefore, by 2008 it will be inappropriate to separate local loop services, PDN services, voice, data, narrowband and broadband into separate product markets. Instead, it is appropriate to consider a single product market for high-speed packet based access for the provision of various telecommunications applications (including voice, video, internet gaming, data etc).

[6] See section 4.2, Telecom's submission dated 29 October 2003; and section B of Telecom's Supplementary Legal Submission dated 12 November 2003.

B No evidence on which to recommend unbundling

Key points:

- The OXERA Model is not suitable for the task at hand as it does not measure dynamic efficiency or the effects of unbundling on innovation and investment.
- When dynamic efficiency is considered, costs of unbundling of an order of magnitude greater than OXERA's predicted benefits are apparent.
- No probative quantitative evidence has been presented in the Draft Report or the Conference such that a recommendation to unbundle can be justified.
- Nor does the evidence on the effect of unbundling in relation to price support the recommendation in the Draft Report.
- No conclusions in favour of unbundling can be drawn from the international evidence.

The OXERA CBA

19. While Telecom supports the use of CBA techniques in general, Telecom submits that the OXERA CBA offers no evidence in favour of unbundling.

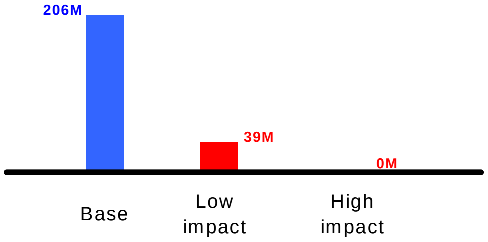
20. To be blunt, the Commission has been let down by its external consultants who have produced a model which is conceptually and theoretically flawed, based on inappropriate data and assumptions, and which contains numerous implementation errors. It is an "absolute shocker", as stated by Roger Kerr yesterday in submissions.

21. Of principal importance are the following:

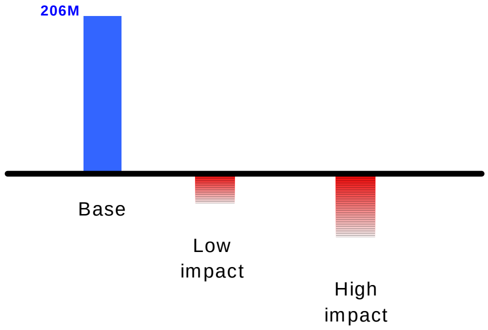
- The OXERA analysis does not consider dynamic efficiency as that term is normally defined and in particular, it fails to consider dynamic efficiency losses from unbundling.
- The OXERA analysis interprets transfers of surplus from producers to consumers as a benefit, in contrast to mainstream cost benefit analysis.
- The benefits under the OXERA model are wholly dependent on unjustified assumptions as to productive efficiency improvements of 3% per annum under the factual.

22. The problems do not, however, stop there. In our 29 October 2003 submissions we list 25 other issues. With more time, I have no doubt that we would have found others. Indeed, more have come to light since our submission was sent in.

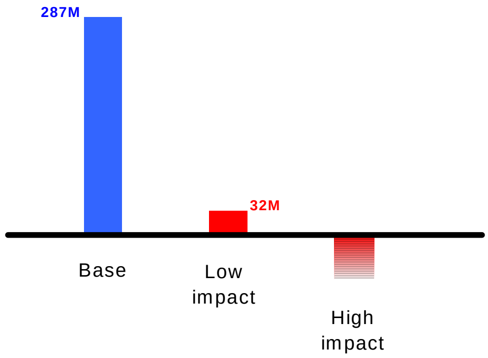
23. As Stuart Shepherd explained on Tuesday, even if the only modifications are to correct 3 errors (voice prices, GST and allocation of fixed costs -- the first of which *increases* the predicted benefits) and align penetration rates to international experience, virtually all of the alleged net benefit disappears from option 1 (full unbundling):



24. If all 7 quantified issues are taken into account, the result goes through the floor:



25. Similarly for PDN (option 4):



26. The same holds for line sharing and bitstream unbundling.

27. Also, remember that there are many other issues which could not be quantified in the time available.

28. Let me give you one more example to illustrate our frustrations with the OXERA CBA and also its lack of consistency with the main body of the Draft Report (see paragraph 151 of our 29 October 2003 submissions). Although the Commission sets a 5 year period for its analysis, the OXERA Report spans 7 years (2004, 2005, 2006, 2007, 2008, 2009 and 2010, although no costs or benefits are said to arise in 2004). Presumably, any benefits associated with the last two years should be removed on the Commission's logic that the quantification of such benefits is too uncertain.

Dynamic efficiency

29. In an illustrative study of the potential dynamic efficiency costs of unbundling, Professor Hausman found that:

- the OXERA model does not account for dynamic efficiency; and

- looking at a single product (cable TV) he estimated benefits to New Zealand consumers of between $2b - $5b and was of the view that the welfare gain was likely not to occur if PDN unbundling or bitstream is mandated.

30. This is an order of magnitude higher than the net benefits predicted by the (uncorrected) OXERA Model.

OSS

31. I do not want to go over the details of the CBA debate that you are familiar with, but there has been an important debate on OSS.

32. TelstraClear has presented a confused picture of OSS. In its written submission it strongly advocates that electronic OSS access be designated as a separate service and points to its own systems in Australia as an example.

33. Yet both Tony Downey of Telstra (wholesale) and Phil Sykes, CEO of Request, whose company uses the systems, called it respectively "gold-plated", "unnecessary" and "overkill".

34. Peter Waters, in the extensive material presented this morning, pushes electronic OSS as necessary to meet non-discriminatory requirements of the Act and promotes this based on recent developments in Australia where the ACCC has the option to take regulatory action if real-time interfaces are not implemented.

35. Telecom restates its support for electronic interfaces, real-time and non real-time, where volumes make it economically feasible and where costs can be recovered.

36. Telecom has estimated that implementing the Australian form of unbundling would cost between $35 and $58 million dollars, including OSS costs. Now, while the Commission has expressed reservations about the size of those numbers, Telecom stands by them, and will work further with the Commission and its consultants in order that they fully understand what is behind these numbers and that Telecom's and any entrants' responsibilities with regard to OSS are also fully understood. The Commission has also asked that TelstraClear provide it with information regarding Telstra's actual on-set and ongoing OSS costs associated with copper loop unbundling. We have no problem with that - our estimates took into account what public information was available on those charges, mainly information included in the ACCC's reports this year on the appropriate prices for the ULLS.

37. We would however, have a problem with Mr Downey's suggestion that the Commission use Telstra's OSS costs for implementing the Australian line sharing service as a proxy for the costs Telecom would incur in implementing OSS for an unbundling service. Line sharing as a service requires a different type of OSS to unbundling either of the PDN or the copper loop. Line sharing is an incremental service to POTS - that is, where Telstra sells a line sharing service to an access seeker, it continues to provide POTS across that same line. That means that the OSS for such things as line testing, fault reporting and maintenance does not need to be altered - it is still provided as part of the POTS service. This cannot be compared to the OSS that would be required for unbundling, where for example, Telecom would have no visibility of the line at all, and could not therefore use its normal line testing processes.

Monopoly rents and rate of return on assets

38. Telecom is aware that these topics have been mentioned in the conference. It also notes, however, that they are not topics on which any data has been sought or provided,

they are not a feature of the Draft Report, and so Telecom has not made submissions on them. Telecom merely notes that, in the absence of evidence on these issues no decision or recommendation can properly be based on them.

Conclusion on the CBA

39. Telecom submits that:

(a) the OXERA CBA is not an appropriate framework or of a standard suitable for being used to justify a recommendation in favour of unbundling;

(b) using the OXERA framework, but correcting errors produces a negative "net benefit";

(c) looking at OXERA's predicted benefits on face value, but in the context of telecommunications revenue generally and the potential dynamic efficiency costs, shows that the case in favour of unbundling is unconvincing at best; and

(d) the Commission has been let down by consultants whose model did not address the task set for the Commission under the section 64 or the Schedule 3 investigation. The OXERA report is demonstrably an unsound basis from which New Zealand's telecommunications industry investment decisions and service definitions could be based.

40. Telecom submits that without the CBA no quantified analysis is left on the record from which a recommendation to unbundle could be based and, therefore, the conclusions in the Draft Report must be revisited.

The effect of unbundling on price

41. One issue which has rightly been very prominent in the Conference has been the question of the effect of unbundling on price. I would like to make a number of points:

- First, as Bob Crandall stated there is little international evidence to suggest that unbundling will lead to significant short or long term price decrease.

- Second, to the extent which OXERA and TelstraClear predict that unbundling will reduce prices, it is predominately in the business data market (as Sykes told us, entrants do not use unbundling to compete on price, but on "value propositions" and they do so at the high end of the business market) with very few price benefits flowing through to the mass market of residential consumers. Residential consumers therefore face a double hit. Not only do they lose the NGN and wireless broadband, they are not the beneficiaries of unbundling (to the extent there are any).

- In fact, residential customers face a triple hit (the unbundling triple play?) as unbundling is likely to have an averaging effect on prices. Take the example I gave on Tuesday of residential Jetstream. Given the dynamics of high fixed cost / low marginal cost investments, Telecom has the natural incentive to use value-based pricing to maximise uptake for as many people who are willing to pay above the marginal cost as possible. Therefore, Telecom provides services at the bottom end of the broadband market at a price close to marginal cost. Now, a regulated wholesale price would inevitably be above the marginal cost with the result that we would not expect these consumers to be supplied in a world with unbundling. Let us be clear. Telecom prices its residential Jetstream services at very close to marginal cost. We have very strong incentives to do so. The cost of a local loop set at TSLRIC will not enable an LLU competitor to compete for residential. For these customers, we would expect prices to rise in an unbundled world and many of them not to take the service. I will say more about this shortly in relation to the NGN.

- I also refer to OXERA's Model. Even with the price reductions forecast by OXERA, when one corrects only the most obvious errors, the net benefit still becomes negative.
- Finally, in my view, the real benefits to consumers - in terms of price, quality and range of services - will come from infrastructure competition.

International experience with unbundling

42. There is very little substantive overseas evidence to suggest that unbundling fulfils policy objectives and expectations.

43. With only a few thousand lines unbundled, of the UK's 29 million lines, local loop unbundling has clearly not fulfilled the objective of increasing broadband uptake in the UK. The ACCC has also recognised that the take-up of the unconditioned local loop service in Australia has fallen considerably short of expectations. Further, recent comments made by the FCC clearly indicate that its unbundling regime has not achieved the desired outcome of encouraging the rapid deployment of new technologies and, as a result, the FCC has deregulated many of the unbundling obligations.

44. The Commission may ask itself why is unbundling common to many countries overseas when, according to Telecom, it has no redeeming benefits. I would note two things. First, the prospect of competing wireless broadband technologies was not present when decisions to unbundle were made in those jurisdictions. Second, unless the regulator is clear that unbundling is transitory in nature, it is politically and pragmatically difficult to un-unbundle once entrants have relied on it. The FCC had no real hurdle to overcome when it ringfenced investment in fibre to the home and DSL, because its prior regulation meant there had been little such investment and little unbundling of it. The hurdle was quite different when it looked at the other unbundled elements.

45. The political and economic pressure for unbundling is different in other jurisdictions. For example, European Union regulators set out on a path of local loop unbundling some years ago when many of the national telcos had recently emerged from state monopolies and current access technologies were not available. Less still were the new technologies which are now being rolled out in New Zealand.

46. The Australian experience is particularly useful. Yesterday Tony Downey discussed unbundling in Australia. He noted that DSL connections projected for 2005 will be half wholesale. He noted that unbundling is focused on CBDs and metro.

47. In New Zealand, you have heard that that is where competition is already strongest and growing stronger with the Woosh rollout. Mr Downey suggested examples of alternative investment in Australia, to illustrate his point that unbundling had not deterred investment. But the examples given were TransACT in Canberra, which covers only a few suburbs, Vic Neighbourhood cable, which covers only two towns and Bright which is very early in its plans, covers Western Australia,

48. For a country with 5 times the population and 4 years down the track, this gives a very clear warning - alternative access investment seems smaller and less competitive than in New Zealand.

Broadband

49. Rosemary Howard gave the best evidence in support of Telecom's position on access competition. Where is broadband penetration the highest? In Wellington where TelstraClear have rolled out network Rosemary tells us, there is vibrant competition between several access providers just as Telecom foresees for other areas in New Zealand.

50. Mr Newman of TUANZ focused on New Zealand's broadband penetration. Mr Newman, being a man who - if I can hijack David Lange's famous quip at the Oxford Union - "Mr Newman is a man so keen on unbundling you can smell the copper on his breath".

51. Yes, we have low residential uptake of broadband. But we have very, very good uptake in business. Are our residential prices too high? No, not even Mr Newman says that - we price at or close to marginal cost.

52. So do New Zealand households have no affinity to new technologies or the Internet? No - they love it! Our narrowband Internet usage in New Zealand is fantastic.

53. Is our Jetstream service poor quality or does it have poor coverage? No - we have 85% coverage - extremely high. As for service quality, our DSL performance is out of this world. Even George Gregan says so. Speeds consistently up to 8 Mps.

54. So why are residential customers sticking with dial up? It's easy - free local calls. Our good quality dial up is adequate for most residential customers' needs. That's why we need to shift to an NGN and offer more compelling services than just fast Internet. That will truly set New Zealand in the vanguard. And it will not just be Telecom's high speed access. As you have heard from all the other access providers, they are happy to take Telecom on with their different mix of prices and services.

C Access competition in New Zealand

Key points:	
•	In 2-3 years time 80-85% of New Zealanders will have a competitively priced choice of infrastructure providers for high speed telecommunications services.
•	The Commission should not second guess those people who are investing real money.
•	Infrastructure competition is superior to competition over one network.

The counterfactual

55. There was a discussion on Wednesday as to whether the Commission has to balance:

- a low probability of a substantial benefit from not unbundling; and
- a high probability of a modest benefit from unbundling.

Although oversimplified for debate, that proposition is a useful framework. I will look at a no-unbundling recommendation in this section and consider unbundling in the next.

Is there a low probability of substantial benefits if the Commission recommended against unbundling?

56. It has become apparent during the Conference that a recommendation against unbundling does not leave the relevant issues unregulated. The Commission has been given commitments by the participants which amount to an agreed counterfactual to unbundling, in which the Commission will have an important role.

57. If the participants wish to behave differently they will be aware that they will face a Schedule 3 investigation into a form of regulation which addresses the departure from the counterfactual and takes compensating regulatory action.

58. The essential components of this counterfactual are:

(a) substantial investment by Telecom in a mass market high speed packet switched network made available to both business and residential customers, providing new services in new ways which consumers will value;

(b) an evolving wholesale access market in which Telecom offers data tails at a price which would enable efficient rivals to compete at retail for multi-site businesses; and

(c) competitive access platforms which will provide effective service and price competition for Telecom in all customer segments.

59. The assurances given by participants, especially Telecom, mean that a recommendation against unbundling would have both a short term and long term benefit to end users.

Short term benefits

60. Telecom would immediately be subject to scrutiny and regulatory threat from December 2003 as to:

(a) its wholesale practices, including the offering of partial private circuits on the terms offered at the Conference;

(b) development of IP interconnection agreements with other networks; and

(c) design and implementation of its mass market residential multi-service NGN.

61. This scrutiny can be expected to result in a deeper competitive wholesale market and lower cost data tail services from mid 2004 and a continued rapid rollout of lower cost DSL enabled residential lines.

62. Telecom and TelstraClear will continue investment in business overlay IP networks. TelstraClear would continue and probably expand its wireless rollout, use Telecom's data tails service and its existing network to compete for SME, commercial and corporate customers. This would reflect the investing entrant's strategy outlined by Dr Milner.

63. The most profitable market will be business services and that is where TelstraClear will continue to compete most aggressively. However, TelstraClear will continue to service residential customers using wholesale and interconnection. For the same reason, Telecom will continue to use multi part tariffs to recover its costs but keep entry-level prices low, in order to maximise penetration of broadband access and services over broadband.

64. Woosh investors will receive a signal that the regulatory environment is more settled, and conducive to investment. Woosh will have to proceed rapidly with implementation of its PROBE contracts and commercial rollout to all centres, if it is to gain the mass which its multi service business plan depends on for long term success. As stated by the Chairman and CEO, Woosh will introduce significant price reductions under a business plan which will address business and residential customers differently, but will aggressively pursue them both in order to acquire scale. Telecom will continue to respond to that rollout, competitively reducing prices and increasing services in response to Woosh, but also pursuing scale.

65. BCL will expand its coverage and will provide price competition for Telecom at wholesale (as their response to Commissioner Rebstock's SSNIP question indicated).

66. Counties Power have said this morning that they have already achieved 2% market share. They are, however, not going to give up - they have stated that that "is not enough for us - we want more".

67. ThePacific.net and the PROBE entrants will provide price and service competition in the business and residential sectors. As their submission states:

> Our business plan is not about cherry picking high value business customers. Though these are the first to join our network it then causes excess capacity outside of business hours. We will then be able to target the marginally profitable residential customers as well.

68. In the short term, therefore, there will be price and service competition and prices will continue to fall.

Medium to Long Term Benefits

69. In the medium and long term, Telecom will likely invest in its mass market multiservice NGN, Woosh, BCL, ThePacific.net, PROBE entrants and Counties Power will continue to roll out wireless access, and continue it with other technologies suited for the scale and geographic location of their customers, as described by Dr Milner.

70. In 2-5 years, the country will be served by at least three access networks in the main cities, at least two networks in the provincial centres and two networks in 85% of the rest of the country. All Telecom's residential customers will have access to multiple services at high speed and many of them will have IP services installed. New Zealand will have competitive broadband networks.

71. The duplicated fixed investments will maximise the pressure on each of them to differentiate and therefore to innovate. Woosh will emphasise its flexibility and portability, Telecom will emphasise its multi-services, PROBE entrants will emphasise their community connections, and Vodafone will continue to emphasise its service and functionality, including roaming. The wholesalers (BCL and Counties Power) will continue to push for market growth through their wholesale prices and services. Most importantly, all participants will seek to take advantage of their points of differentiation and will compete based on their marginal costs, not the average cost of the unbundled network. It is competition of this nature that offers the best hope of early delivery of broadband to the maximum number of customers.

72. If this counterfactual fails to emerge after, say 2-3 years, the Commission has the option at that time to investigate and recommend regulation in a form which addresses the failure specifically, that would substantially reduce the current uncertainty over the nature of the regulation being considered.

73. In conclusion, there is clear evidence from the Conference that a recommendation to not unbundle would have a certain consequence of substantial short term and long term benefits. It would result in productive changes to the wholesaling of access services, it would encourage further investment in access platforms, and in the medium term it would result in competition between mass market IP networks which provide a range of product differentiation and would be priced at a level and a structure which would expand the market and set efficient prices.

D The risks of unbundling

Key points:
• Telecom's NGN is a unique investment proposal. It is quite different from business overlay NGNs being implemented elsewhere. It offers New Zealand the opportunity to have the first mass market multi-service IP based network. That investment will be made riskier and therefore less likely to proceed in the form planned at present. Residential customers who would receive the benefits of this investment would be deprived of them by unbundling.
• With unbundling, investments by Woosh, BCL, Counties Power, Pacific.Net and others will be scaled back, delayed or abandoned.
• Unbundling therefore put at risk the introduction of new services, genuine price competition and benefits to residential as well as large corporate customers. The dynamic efficiency costs swamp the benefits predicted in OXERA's Model.

74. **Is there a high probability of modest benefits from service competition if the Commission recommends unbundling?**

Short term

75. In the short term, nothing will happen. The participants will review their positions. The inevitable and time consuming process of introducing unbundling which has been observed in comparable countries will unfold. The evolution of the wholesale markets for access services will slow, if not stop, as BCL reassesses its investment strategy in the manner described in its submissions. Telecom will assess whether the competition goals of unbundling mean that the wholesale determination still applies in those geographic regions where unbundling is intended to occur. Unbundling will be a substitute for data tails offerings by Telecom.

Pricing

76. The Draft Report proposes that the pricing principle would be average cost-based. The challenges of establishing an average cost of a network which faces radical year on year relative and absolute cost changes are enormous. With broadband, the denominator will be enormous. Other regulators do not attempt to cost-based regulate even the current form of IP networks, which are at least in existence. Telecom's NGN is more complex and relies on later technology than others.

Medium and Long Term

77. In terms of the effects of unbundling on a new entrant, I refer to the presentation from Woosh. The following three effects were identified:

- Because of experiences overseas, unbundling will create financial market aversion to investing in a new infrastructure entrant;
- The "promise" of unbundling will create uncertainty in the mind of consumers who may delay a decision they would otherwise make to switch to the new entrant; and

- Entrants who compete using unbundled services will likely "skim the cream" by targeting high value business customers (particularly corporates). This will do two things. First, it will deprive the infrastructure entrant of access to the relatively more profitable parts of the market if these profits are competed away. And second, it will make it more difficult for the infrastructure entrant to enter in both the business and residential markets to get a balance of daytime and night-time traffic.

78. All of the people who are putting their money into new access investment, BCL, Woosh, Pacific.Net, and Telecom, are telling you "don't do this". They are the people that are best placed to comment on the likely effects of unbundling on investment and industry dynamics.

79. The long term consequences of an unbundling recommendation would also depend on the exact terms of that recommendation. In the case of copper unbundling, there would be no new investment relating to residential customers by entrants. There is no evidence from submitters seeking unbundling to suggest that there is likely to be any significant investment in this sector.

80. There would be some investment by unbundling entrants in the businesses market, who would have the free option extensively discussed by Telecom's economic experts.

81. That combination of new entrants' occasional entry into the business segment and no significant entry into the residential segment calls for my final comment on a major theme of the conference, namely price differentiation.

82. Mr Borthwick asked a question yesterday of BCL. It was to the effect "well, won't other network based competitors compete away the cream anyway - so unbundling won't make a difference in that respect". Well, the answer is absolutely it will. Based on advice from our economic experts, it is Telecom’s submission that value-based price differentiation:

    (a) is a feature of high sunk cost/ low marginal cost industries like the industry in which we operate;

    (b) is a feature of competitive markets with these characteristics, and not an issue of market power;

    (c) is most commonly associated with pricing to some customer groups that is below the average cost and at or above marginal cost of service; and

    (d) increases the size of the market for the services provided by the network, and therefore has the twin virtues of increasing the number of customers served and increasing the aggregate revenue available to fund new network investment.

83. For Telecom and for other network builders, inter-platform competition constrains pricing but, in such a market, all network builders have the same incentives to make efficient pricing choices. They must make a tradeoff between the short- term competitive effects of reductions in prices to high value customers and the long-term effects of reducing the funding available for tomorrow’s network. The choices, and the incentives, are the same for all. In such a market we can, therefore, expect a balance between short-term and long-term competition that will maximise the long-term interests of end users. That's why even where there are plenty of airlines, you still get a big difference between economy and business class seats.

84. However, entrants who lease facilities at regulated cost-based prices have different incentives. They are not forced to constantly take risks and make investment decisions (some of which inevitably fail) aimed at remaining competitive in an ever more dynamic and rapidly changing market.

85. TelstraClear has presented several slides which show Telecom's NGN sitting behind, and separately to, what TelstraClear calls Telecom's "common access network" - its DSLAMs and copper loops. I just want to remind you of Dr Milner's earlier presentations on our planned mass market NGN - Telecom's *DSLAMs are part of the multi-service NGN* - any regulated access to them involves regulated access to that NGN. We should be clear here - TelstraClear are not asking for what they give AAPT in Australia. Whey they say bitstream, they are asking for Telecom's NGN at cost.

86. That would be highly attractive to new entrants unwilling to build their own network because it requires virtually no investment in infrastructure by the new entrant. Instead, the new entrant is reliant on the network builder's investment. We have also made it clear that if we are forced to unbundle our NGN we will have little incentive to build it.

87. To illustrate this point, I would like to use the analogy of the WestpacTrust stadium here in Wellington. This may seem simplistic, but in reality this is a simple point which can be concealed in its more sophisticated versions.

88. The stadium relies on value based price differentiation in order to maximise use and increase its profitability. The costs of the stadium are largely fixed - they have to be met, regardless of how many people come through the turnstiles. The costs of individual events do not vary greatly.

89. However, the price charged can vary dramatically by event. For example, the price charged for a Robbie Williams concert would be high, but the cost of an event where the organisers cannot afford to pay much, such as a local Polynesian dance festival, would be a lot lower.

90. All that the stadium is doing is price differentiating in order to maximise demand and usage and ensuring that less profitable users of the stadium still get to use it. Now let us imagine the stadium is regulated. A cost study is carried out and an average cost of $100,000 per event is calculated. The stadium is ordered to rent the whole stadium to all comers for $100,000 per day.

91. What will happen now? Arbitragers are immediately on the scene, offering great deals to rock concert organisers. Robbie Williams is very happy. He was paying $600,000 before. He pays a whole lot less and makes $2 million profit from the concert instead of $1.5 million. The local Polynesian dance festival organiser is not happy. Being on a shoestring budget, the Polynesian dance festival doesn't have $100,000, so has to cancel or find an inferior venue.

92. Given their costs are sunk the stadium owner thinks about still offering the Polynesian dance festival organiser the stadium for, say, $10,000. The stadium owner also soon realises that in fact attracting the Polynesian dance festival to the stadium will reduce their regulated average cost next time it is calculated. They have no choice but to accept fewer nights of use and a smaller aggregate contribution to the fixed costs of the stadium. In the long run no facility like our WestpacTrust Stadium could be run in such a way. The usage of the stadium would plunge. The market would shrink and there would be a lot less income to fund the stadium.

93. But so far I have assumed that the stadium is up and running and thus the fixed costs are already sunk. But what if the stadium owner realises how much better off everyone

would be, and how many more rock concerts could be attracted, if the stadium had a retractable roof to ensure a reasonable environment for spectators and performers even when Wellington's weather is at its worst? Regulation that effectively prohibits value-based pricing will undermine the business case for the retractable roof, delaying it or even forcing it to be abandoned forever.

94. Those that will pay the cost will be customers – particularly low end residential customers – who will not receive services that they otherwise might receive. Economists call the losses resulting from the inability to obtain new services losses in social welfare. For example, Telecom already prices many of its residential broadband offerings (such as Jetstart) at or just above marginal cost. Regulation based on TSLRIC principles would remove Telecom's economic incentive to do so.

95. This will mean the loss of new services such as Cable TV and many potential customers simply being not served. Professor Hausman has calculated the cost of not making a cable TV over DSL service available to consumers to be in the billions of dollars. Such potential costs dwarf the benefits calculated by OXERA – even if we assume OXERA's figures have any validity.

96. In conclusion, a decision to recommend unbundling would result in an immediate slowing of the evolution of wholesaling of access services and a pause in price reductions. In the medium term it would undermine the evolution of the wholesale market which depends on evolution of access investments by wholesalers and also is encouraged by the Commission's determination earlier this year. There would be some entrants' investment in access investment focused on business customers, but no significant investment by them in residential. Telecom would reassess its planned mass market NGN in light of its changed investment environment and the expectation of a trend to a single, average cost based price for access services, which would shrink the size of the overall market.

E Unbundling is not a now or never decision

Key points:
• Woosh has said it needs a year to 18 months to prove itself.
• By recommending not to unbundle at this time, the Commission will be able to make a decision which will be informed by the market developments discussed in the Conference.

97. Given the uncertainty referred to above there must be a significant risk that a recommendation to unbundle Telecom's network could be made in error. Telecom submits that this risk of error requires a cautious approach and a presumption against unbundling because:

(a) the Commission is not faced with a "now or never" decision (that is, a decision to unbundle can be made in the future when the current period of dynamic change has stabilised);

(b) once unbundled, there will be significant practical and political pressure against reversing unbundling even if it turns out to have been the wrong decision; and

(c) the potential consequences of unbundling in error are substantial. The costs to society of the delaying or abandoning in the introduction of new technologies are an order of magnitude higher than the purported benefits of unbundling.

98. The issue has arisen whether this requires the Commission to attach possibilities to the different outcomes.

99. Telecom submits that a standard options analysis is simpler. I refer to Professor Hausman's analysis on Tuesday:

(a) The Commission should take Telecom's plans to develop a multi-service mass market NGN at face value, accepting that this is not a guarantee.

(b) The Commission should also recognise that it has the option of waiting a couple of years. If the NGN does not go forward or if wireless competition does not develop it can regulate then.

(c) On the other hand, if the Commission regulates now, it should recognise it will almost certainly block the mass market version of the NGN and competitive infrastructure build.

(d) Therefore, an options analysis approach would suggest that the Commission should defer a final decision until more information becomes available over time.

100. There is another benefit of a no-unbundling outcome with a potential review later.

101. This investigation has been conducted under timeframes set by Parliament. Those timeframes have resulted in a Draft Report being issued at a time when the complexities of data networks as they exist and as they are evolving were extremely difficult to come to grips with. This is illustrated by the various different overseas services referred to in

the Draft Report, and the OXERA CBA, which, as we have pointed out in our submissions (paragraph 68), lead to an apparently opposite regulatory conclusion being reached about two services which are described differently but in substance are the same.

102. That's no way to run a country. Decisions taken in haste, especially highly complex commercial, technical and economic ones, almost always turn out to be wrong.

103. This is asymmetric risk of another sort. Action in haste and confusion has a higher risk than deferral, reflection and a fully informed analysis.

Conclusion

104. I said in my opening this conference was a competition between the network builders club and the unbundlers. A competition between Reuben Thorne - quietly getting on with the job of transferring a certain piece of silverware across a certain stretch of water. And on the other hand George Gregan yapping at the ref.

105. Well we've seen this in action during the week. The network builders have been here in numbers and here in force. Chief executives or chairman of Woosh, BCL, Counties Power and Team Talk. I think we can safely say Telecom has been here in numbers as well.

106. The unbundlers - well its worth reflecting here that only one - TelstraClear - so only one actual investor in New Zealand telecommunications has appeared this week in support of unbundling. This speak volumes. But outside in the real world the network builders have continued their jobs. Investment and innovation never sleeps when you've sunk big money into networks.

107. So what's happened even during this week while George has been telling the ref that Chris Jack was offside and should be yellow carded. Well for starters on Tuesday BCL opened its network covering 600,000 customers. Today the Government announced BCL and Telecom have won PROBE contracts in Wanganui/Manawatu and the West Coast. Counties Power have won the PROBE contract for Auckland. All in one week. What will life be like in 5 years.

108. The reality of network competition is here - now. It cannot be ignored. The potential is huge. On the other hand, unbundling carries with it huge risks.

109. You should not therefore regulate. You should of course monitor the promised made by the network builders club, but you should give the industry a chance to prove they can deliver the goods for customers.