Telecom

**COMMERCE COMMISSION CONFERENCE ON SECTION 64
AND SCHEDULE 3 INVESTIGATIONS
WHOLESALING DEVELOPMENT IN NEW ZEALAND:
13 NOVEMBER 2003**

1. In this session, I want to outline the wholesale environment, and how that will develop over the next two years. I also want to respond to a couple of specific questions which were asked during Tuesday morning's session, which we have been thinking about since then.

Telecom's wholesale services group

2. Prior to assuming my current responsibilities, I was responsible for establishing Telecom's wholesale services group in 1998. This group is now headed by Tim Lusk, and has grown substantially since its establishment.

3. The goal of the Wholesale Services Group is to provide professional service to wholesale customers by winning business from them on a price and non-price value. The Group encourages maximum diversity of retail offerings through competing suppliers in increasingly vibrant telecommunications markets.

4. The wholesale business has a sales turnover running to some hundreds of millions and is thus significant in terms of Telecom's total New Zealand turnover. That business is growing - and that's excluding the outcome of regulation and that's only now just starting to feed through. Our wholesale business has grown for good commercial reasons - the business targeted growth opportunities and been successful in winning that custom.

5. A good example of this would be the value added reseller market players. These firms have business models based around certain types of calls like 0800 that often involve call centre activity, or voice/data connectivity to specific parts of the world. We have been successful in achieving year on year growth rates that exceed 20% in this category through providing great service at a good price.

6. Our wholesale customers have different needs including:

   - Service competition - value added resellers/ISPs who want network based service from Telecom either under existing unregulated commercial offers or regulated wholesale offers. They take this service and add billing, linguistic or technical competencies in order to meet customer need.

- Offer completion - typically these services are provided to smaller carriers who interconnect with Telecom to provide voice service but expand their offer with additional product. In addition to Interconnect they purchase regulated and unregulated wholesale services.

- Network completion - typically this group comprises larger carriers who have product capability and simply seek to complete their network reach. In a voice sense network reach is achieved via interconnect. I want to come back to this service in a minute, but first I want to explain what I believe are the underlying drivers for the evolution of wholesale services.

What drives wholesale market development

7. An unusual but important aspect of this wholesale activity is that it is driven by **both** commercial and regulatory evolution. Our firm belief is that there must be a strong commercial driver. We believe that it is far better to recognise the commercial incentives at play, set up an environment where different incentives can be aligned and let the market work. Without that, wholesale would just be regulatory compliance with the regulator being an ever present participant.

8. The development of wholesale also requires an attitude change. There must be a set of market behaviours and expectations by all participants which will enable a genuine wholesale market to emerge and evolve, under which participants see a greater benefit in dealing with each other commercially than in just gaming the regulatory arbitrage opportunities.

9. Participants must want to get on with playing and winning the commercial game, rather than spending their time talking to the referee. Telecom's submission here is that this half regulatory, half commercial game is just a transition to a truly commercial environment where commercial and engineering advantage and opportunity will prevail, and where regulation provides the framework, not the moves. The longer the referee is drawn into every move, the longer the transition will take. Overactive regulatory intervention would be truly counterproductive to the shared objectives of genuine competition at wholesale level.

So what will cause this commercial development?

10. It might be useful to reflect on some of the big macro issues that will impact on the environment. I would suggest to you that there are (amongst others) three:

- the first is the need for networks to figure out IP interconnection;
- the second is our old favourite, the rise of alternate networks; and
- the third is regulatory intervention.

Starting with IP Interconnection

11. PSTN networks interconnect. Standards are well developed such that voice calls traverse different networks in a way invisible to customers. We don't even think about it. I ring my friend in London and it works.

12. The PSTN is of course a giant public network. In the data world we have a giant public data network. It is called the Internet. Again, we don't even think about it - I can email anyone in the world who is connected. The Internet is a creation of Internet peering - a set of agreements whereby data traffic is exchanged. The Internet we know has limitations. It is a network that cannot guarantee a level of service from end to end. Your file might pass through the most recently installed router in Australia, but it might then go through an overloaded router in Bulgaria on its way to my friends in London. As Dr Milner explained, this makes the Internet great for a service like file transfer of a document or an email but no good for voice or many video applications where a guarantee of a grade of service from end to end is required, And so we need a new form of interconnect that supports multiple services.

13. As an industry we need to recognise that significant customer/industry benefit will flow from development of a public data network. This will centre on "connectedness" between willing data networks and interconnect agreements that meet the specific service requirements of IP customers.

14. But there is a way to go yet. For starters, what happens in an IP network world when an IP voice customer wants to talk to another person who is on another IP network? The answer is the IP stream carrying the voice must be handed over at an agreed point of handover and the receiving network must know the quality standard required for that voice IP stream and guarantee to terminate the IP call at the other end at the required level of quality.

15. When the next IP stream arrives and it is two schools wanting to videoconference over IP and the schools are on different networks, then the two networks need to understand again what is the type of traffic being delivered and guarantee to deliver it.

16. It is important to recognise the inevitable tide which will flow in when these issues are addressed and resolved. IP interconnection, combined with the rise of multiple networks in New Zealand will produce the environment for genuine commercial exchanges at the wholesale level.

17. Clearly, this is a significant issue for the industry that won't be resolved overnight. Rather, it will play out over a period of time as industry participants reach agreement to deliver data services that both of their respective customers want to enjoy. This is a current topic of discussion within the broadband interoperability forum convened by Industry NZ.

18. Fortunately, there is growing commercial pressure to resolve these issues promptly, as the world moves to IP, and as new IP networks spring up in New Zealand.

Alternative Networks

19. The second issue impacting on wholesale relationships is the arrival of alternative networks. Anyone who heard Woosh yesterday will now understand why Telecom is taking these very, very seriously. They prove 80-85% nationwide coverage in 2-3 years of a network that matches the functionality of copper.

20. BCL and Counties Power have made submissions explaining their business plans, and you will hear from them later today. The key point is that they plan to offer wholesale services only. They will be competing for Telecom's customers.

21. As new entrants such as BCL, Counties Power, and other firms provide competing networks, it will be in all firms' commercial best interests to achieve commercial agreements which allow expansion and profitable operation. Some of these new entrants will be entirely wholesale networks and they will want to provide services to retail customers utilizing other firm's networks such as Telecom's or TelstraClear's.

22. Telecom will find it in its commercial interests to provide services to new entrants because the new entrants will increase demand and provide an additional revenue source to Telecom. Indeed, to the extent that the new networks can provide wholesale network operation more efficiently than the Telecom network, in certain geographical areas or for certain type of customers, Telecom will find it in its economic best interests to utilize them to serve its own customers rather than relying on the Telecom network to provide the entire service. Thus, the new entrants have an economic incentive to cooperate with Telecom, and Telecom has an economic incentive to cooperate with the new entrants, especially if they can lower the overall cost of providing the service.

23. Not surprisingly these issues have come into prominence with the PROBE process. The Government has made it clear that interoperability between PROBE networks is a critical issue to sort out. Arising from PROBE is a process for starting to work through these issues. Telecom is an active participant in this process and sees the Industry Forum doing much of the heavy lifting.

Regulation

24. The final piece is the influence of regulation. Since the passing of the Telecommunications Act two years ago, we have faced considerable uncertainty over the nature and extent of regulation of the wholesale market. Some of this has been removed with the wholesale determination earlier this year. However, much uncertainty still remains with the current investigation and the procedures which will follow it, before we know the shape of the regulatory framework. That has been an impediment to the evolution of the market and has probably held us back from addressing the issues.

25. I would say that there is now a window of regulatory opportunity as the wholesale determination is working through the industry. The expectations and skill base of the participant, are changing and there has been a surge in wholesale activity which shows up in the graph at paragraph 30 of Telecom's submission on the Draft Report.

26. Telecom has reflected on Commissioner Webb's observations yesterday about the judgement which must be made between what has been described as a small but assured benefit from service based competition versus the uncertain but potentially substantial benefit from facilities based competition. It seems to us that the service based competition from wholesale is potentially a significant and immediate benefit, perhaps foreshadowed by the surge in wholesaling since the determination. However, that would be dampened by the ongoing uncertainty a recommendation for unbundling would impose, and the consequent delay in development of wholesale products and the wholesale market. Telecom sees an alternative if the evolution of these wholesale markets could be freed of this intervention.

Where does that leave data tails?

27. Now I want to turn to the questions asked by the Commissioner Rebstock about data tails.

28. There are many ways in which the issue of data tails is addressed around the world, and the outcome which is best for the relevant participants, the available technology and the

state of evolution of the relevant markets is not straightforward. It does not lend itself to a single imposed solution.

29. Before considering these, it should be noted that this issue will reduce in significance of its own accord. Why should this be so? I doubt if there's a person in this room who would not share the vision of New Zealand having a public data network that represents all willing data networks being connected - or interconnected. If all willing data networks are interconnected then network A can talk to network B. And if network A has a data customer on network B then service can be provided by means of interconnection. And if data interconnection, both IP and otherwise, occurs then what role does a partial private circuit play? Answer - probably none.

30. So in terms of our mindset here we do have to be careful that we do not project the solution to the problems of the past/present - connectivity across private data networks into the future - where the imperative is to achieve connectivity across any willing data network. The key to this is to recognise that we are in a transition phase and that partial private circuits have a role to play in this transition - but that will reduce over time. For example, in the PSTN interconnection world the links between Telecom and other networks are not treated as retail services. We see the need to move data tails more into an interconnection model as one step towards resolving bigger emerging issues around IP interconnection. This would therefore involve access seekers having the option to build their own access to the interconnection point of presence rather than having to buy it off Telecom.

31. Let me get back to the immediate question asked by Commissioner Rebstock. We currently have an effective data tail offering. Commonly based on stacked wideband with tails going from that stack to the end customer. We provide this service for very large corporate customers like a bank or Fonterra and we use it for TelstraClear so TelstraClear can "fill in the gaps". That is to enable them to for example supply all 10 sites of a company when their network only reaches 8 out of 10. They have been using this service extensively and capturing a significant share of the multi-site business data market.

32. We have been giving considerable thought to this service in the broader context of how we see the need for data interconnection developing. While now is not the time to discuss this in detail, I would like to articulate some high level principles:

- The concept of any one network being an island is not an option. Our aim should be the IP equivalent of the PSTN - but with multiple services - not just one - that is voice. By this I mean interconnection must create a multi-service IP public network that will allow anyone to communicate with anyone else on the same large interconnected public network.

- These arrangements should be symmetrical. We are talking here about network to network interconnection that should be underpinned by a relationship of equals. Even if one is a large and one is a small network. This is not dissimilar to PSTN local interconnect where pricing is symmetrical even when it is Telecom interconnecting with a very small player.

Telecom's Initiative

33. In this period of transition, we would acknowledge that there is a particular market issue that we need to ensure is solved in a fair manner.

34. Telecom is giving a commitment at this Conference to reshape its current data services, taking them more towards an interconnection model. Telecom is committed to resolving the partial private circuit issue within a reasonable time frame and at a pricing level at which an efficient rival can compete.

35. We intend to offer a data tail service with the following characteristics:

- It will be a service that will allow an access provider to "fill in the gaps" where the network does not reach all the sites of a multi-site customer

- The handover point will be defined by the access seeker - that means in simple terms they can use their network where they have it and use ours when they want. We won't make that decision for them

- In terms of price we will price the data tail in such a way that an efficient rival can compete with Telecom at retail

36. On this last point this price standard is one we would be happy to stand up and be measured against.

37. This solution works in the context of an evolving wholesale market, as I have described above. It depends on a removal of the regulatory uncertainty which an unbundling recommendation would impose.

Conclusion

38. Telecom sees the wholesale issue as follows:

(a) Telecom delivers a range of wholesale services to a number of wholesale customers. It is an important part of our business, and one which we are actively and aggressively growing.

(b) There is a sound regulatory framework now in place and this is leading to an increasingly skilled set of participants who will apply those skills and attitudes in a widening wholesale market.

(c) The commercial environment for this widening wholesale market is not yet fully in place, but is emerging as this investigation proceeds. That commercial environment will establish the incentives for an active and efficient market, for more than hands on regulatory intervention.

(d) Key to the commercial environment is the emergence of multiple networks for which the catalyst is PROBE. A signpost for future evolution is the emerging service specific IP interconnection regime being developed at present.

(e) Telecom has offered several data services which it believes meet the needs of its customers, both wholesale and retail. Telecom believes that the evolving market should not be constrained by adopting a regulatory service and imposing it on all customers and Telecom.

(f) Telecom undertakes to reshape its partial private circuit offering. The price will be one at which an efficient rival can compete with Telecom at retail. An unbundling recommendation would block that undertaking entirely.

(g) Telecom is aware that Telstra's pricing of similar services has been subject to regulatory intervention, as has British Telecom's. It realises that if it does not honour its undertaking to provide a price at which an efficient rival can compete, George Gregan will have something to say, as will the referee.

(h) Telecom will provide a fair and workable solution which it is confident will avoid the need for any such intervention, and will place New Zealand ahead of both Australia and United Kingdom as having a commercially incentivised wholesale market.