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Memorandum

TO: David Knight and Vanessa Oakley
Telecom Corporation of New Zealand Ltd

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BITSTREAM ACCESS: WHOLESALE PRICE CALCULATION

1 Introduction and summary

- 1.1 You have asked for my advice on whether the approach adopted by the Commerce Commission to the calculation of the “uniform bitstream access price” in its “Statement for Consultation” dated 12 October 2005 is consistent with the Telecommunications Act 2001.
- 1.2 In my opinion the Commission’s proposed approach is wrong as a matter of law. The proposed approach is not consistent with the approach required by the applicable Initial Pricing Principle (“IPP”), and is not consistent with the scheme and purpose of the legislation. There are two related errors of law that I have identified:
 - 1.2.1 the proposed approach does not impute a retail price for the unconstrained speed regulated service by reference to retail prices for services that are comparable on dimensions relevant to retail price, in particular downstream speed. This is inconsistent with the IPP, both as a matter of ordinary language and having regard to its underlying policy;
 - 1.2.2 the Commission has not considered the relative efficiency of requiring Telecom to provide a single unconstrained service at a single price, as compared with multiple services at different downstream speeds and different prices. Such a comparison is required by ss 18 and 19 of the Act.
- 1.3 It is not in the interests of access seekers (or, of course, Telecom) for the Commission to proceed on the current basis, with the questions of law identified above being decided by a Court some time after a decision by the Commission.

Under s 60(3) the Commission's determination would be effective unless and until set aside by a Court. But:

- 1.3.1 the market structure would be altered, potentially quite swiftly and irreversibly, in a manner which appears unlikely to be in the long term interests of consumers (though this has not been the subject of a proper efficiency analysis by the Commission, to date);
- 1.3.2 access seekers would face the risk of a backdated price increase if the challenge is successful, which they would not be able to recover from their downstream customers. If my advice is correct, and the pricing of a single unconstrained service should be based on the current retail prices for Telecom's highest speed (and most expensive) services, the backdated price increase could be very substantial indeed, and would make provision of services to many end users uneconomic. This prospect is likely to create uncertainty, and deter uptake of the regulated service.
- 1.4 On the other hand, it is not in the interests of access seekers or the public for a decision by the Commission founded on a correct interpretation of the Act to be delayed for a lengthy period while these issues are considered by the Court.
- 1.5 If the Commission agrees with the reasoning in this advice and alters its approach, these concerns will not of course arise.
- 1.6 If the Commission is not fully persuaded by the analysis in this advice, but considers that there is real doubt about whether its approach is correct as a matter of law – and in my view that at least must be acknowledged – then it seems to me that the most practical and responsible course of action for the Commission would be to cooperate with Telecom in having these questions of law determined as a matter of urgency before the Commission issues a final determination.
- 1.7 This could be done either by the Commission stating a case for the High Court under s 100A of the Commerce Act 1986 (which applies in this context by virtue of s 15(j) of the 2001 Act), or by the Commission or Telecom seeking a declaration.
- 1.8 If the Commission declines to state a case or apply for a declaration, or to cooperate with an application by Telecom seeking a declaration, then in my opinion Telecom should consider making an urgent application for judicial review to ensure that this matter can be determined as a matter of urgency.
- 1.9 The reasons for these views are set out below. I would be happy to discuss these issues further with you, or with the Commission (to whom I understand this advice may be provided).

1.10 For the sake of completeness, I note that I have not been asked to advise on other aspects of the Commission's Statement for Consultation, or of the Draft Determination of 21 April 2005. In particular, I have not been asked to express a view on whether other aspects of the Commission's approach are consistent with the Act, and I am not in a position to do so in the time that has been available.

2 The legislation

2.1 The purpose of the Telecommunications Act 2001 is to regulate the supply of telecommunications services (s 3). The purpose of Part 2 (the relevant Part for present purposes) and of Schedules 1 to 3 is set out in s 18, which provides:

18. Purpose—

(1) The purpose of this Part and Schedules 1 to 3 is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand by regulating, and providing for the regulation of, the supply of certain telecommunications services between service providers.

(2) In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand, the efficiencies that will result, or will be likely to result, from that act or omission must be considered.

(3) Except as otherwise expressly provided, nothing in this Act limits the application of this section.

(4) Subsection (3) is for the avoidance of doubt.

2.2 Section 19 sets out certain mandatory considerations to which the Commission must have regard in making determinations and other decisions under Part 1:

19. Commission and Minister must consider purpose set out in section 18 and additional matters—

If the Commission or the Minister (as the case may be) is required under this Part or any of Schedules 1 to 3 to make a recommendation, determination, or a decision, the Commission or the Minister must—

(a) consider the purpose set out in section 18; and

(b) if applicable, consider the additional matters set out in Schedule 1 regarding the application of section 18; and

(c) make the recommendation, determination, or decision that the Commissioner or Minister considers best gives, or is likely to best give, effect to the purpose set out in section 18.

- 2.3 The Telecommunications (Fixed Public data Network) Order 2004 added “access to and interconnection with Telecom’s fixed PDN” (“bitstream services”) into subpart 1 of Part 2 of Schedule 1, as a designated access service for the purposes of the Act.
- 2.4 TelstraClear has applied to the Commission under s 20 to set price and non-price terms for access to bitstream services. The Commission is required to make a determination in respect of these matters under s 27. The determination is required to address, among other matters, the technical specification of the service that Telecom will be required to provide (“the regulated service”), and the price to be paid by the access seeker for that service (s 30).
- 2.5 The determination must be made in accordance with (among other things) the applicable access principles and any limits on those principles (as set out in Schedule 1), and in accordance with the applicable initial pricing principle (“IPP”) (s 29).
- 2.6 The applicable IPP for bitstream services is set out in Schedule 1. If the Commission finds that Telecom faces limited competition in the relevant market (as it has in this case), the applicable IPP is:

“retail price (as imputed by the Commission having regard to any comparable service) less a discount benchmarked against discounts in comparable countries that apply retail price minus avoided costs saved pricing in respect of the service”.

3 The Commission’s proposed approach

- 3.1 The Commission published a draft determination on 21 April 2005, and has subsequently consulted further on certain aspects of the application. On 12 October 2005 the Commission published a “Statement for Consultation” setting out its current view on the appropriate form the regulated service should take, and certain other issues including how the initial pricing principle applies to the regulated service.
- 3.2 The Statement of Consultation records the Commission’s “considered view ... that Telecom should be required to provide TelstraClear with bitstream access with a downstream PIR at the maximum technical capacity of the DSLAM (hereafter described as an ‘unconstrained service’).” I understand that the maximum technical capacity is approximately 7.6 Mbps.¹

¹ The draft determination also proposed that the regulated service would be an unconstrained service. On 30 August 2005 the Commission indicated (in a proposed technical specification issued on that date) that it had changed its view on this issue, and considered that it was necessary to limit the downstream PIR to 3.5Mbps, for technical reasons. The Commission has now however reverted to its earlier view that such a limit is not required.

3.3 The Statement of Consultation also records that the Commission considers that there should be a single uniform wholesale price for the regulated service, without distinguishing between whether the service is supplied by the access seeker to a residential or business end-user.

3.4 The calculation of the uniform access price is set out in some detail in the statement of consultation. The first step is to impute a retail price for the regulated service. Paragraphs 30 to 32 summarise the imputation process:

“31. The imputation process is summarised as follows:

- (i) remove ISP charges from the retail list prices of the residential Jetstream plans;
- (ii) calculate the calling discount attributable to Jetstream from a bundle including ISP services, tolls spend per month (average per end user), and the stand-alone Jetstream price;
- (iii) deduct data transmission charges from the Jetstream services for residential Jetstream retail offerings using linear regression, by taking the data cap as the independent variable and adjusted monthly retail price as the dependent variable to remove effects of transport;

32. The y-intercept of the regression is the imputed access price of the bitstream access service from which avoided costs saved must be deducted. The amended steps to impute the retail price are described in further detail below.”

3.5 In performing this regression analysis, the Commission has used only Telecom’s residential Jetstream service plans. It has not included Telecom’s business plans. And it has given equal weight to all the residential plans, regardless of downstream speed. Put another way, the Commission has assumed that downstream speed is not a factor relevant to the setting of retail prices, and has sought to explain the prices of existing services, and impute a retail price for the regulated service, solely by reference to data caps.

3.6 The Commission’s reasons for this approach, and its conclusion on the imputed retail price, are set out in paras 34-35 of its statement of consultation:

34. To calculate the uniform wholesale price, it is necessary to use only Telecom’s Jetstream residential plans in the linear regression. The inclusion of business plans together with residential plans into a single regression does not provide statistically meaningful results, reflecting the small size of the data set and significantly different retail price constructs between residential and business customers charged by Telecom.

35. The Commission is satisfied that the use of residential plans only is likely to provide an acceptable explanation of the removal of transmission from the retail prices. Given the significant proportion of residential Jetstream customers relative to business customers, it is likely that Telecom is recovering the costs of providing the bitstream access to residential

customers without cross-subsidisation from business to residential customers in respect of the bitstream access component. Furthermore, as previously noted, the network costs associated with the provision of residential and Jetstream plans are unlikely to differ.

36. Regressing the data cap and the adjusted residential Jetstream plans provides a statistically significant intercept of \$31.63 representing the estimated price when transmission is removed. Based on this, the Commission considers that the retail price of the access only component of the Telecom residential Jetstream service is \$31.63 (excluding GST).

3.7 From this imputed retail price of \$31.63 the Commission then deducted a discount of 16%, to remove benchmarked avoided costs saved. The result is a price of \$26.57 (GST excl).

4 Interpreting the IPP: ordinary meaning of “comparable” in this context

4.1 The IPP requires the Commission to impute a retail price having regard to “any comparable service”. The use of the term “comparable” raises the question “comparable on what dimensions?”. In circumstances where the purpose of identifying a comparable service is to impute a retail price for the regulated service using the retail price of the comparable service as a starting point, the answer must as a matter of logic and purposive construction be: comparable on the dimensions of the service that are relevant to retail pricing.

4.2 Thus, to begin with the simplest case, suppose that the regulated service is identical in all respects to a retail service offered by Telecom. Plainly the comparable service to which the Commission must have regard would be that identical service. The retail price for that identical service would be the starting point, and an appropriate discount to reflect avoided costs saved would be applied to that retail price.

4.3 In this simple case it would not be appropriate to look to another service that has significantly different characteristics and is supplied at a significantly different retail price (whether higher or lower), merely because the cost to Telecom of providing that different service was the same as the cost of providing the regulated service. The fact that the two services cost the same to provide would not make the two services “comparable” as a matter of ordinary usage. A user would not describe the two services as comparable. From the provider’s perspective also they are not comparable since they differ on dimensions that have a material impact on price. (Nor, as discussed below, would looking to the retail price of the different service be consistent with the policy underpinning the IPP, and the retail minus approach it embodies.)

4.4 Next, suppose that the regulated service is the same on most dimensions as a range of services offered by Telecom (S1 to S9), but on one dimension, which is a key driver of pricing for the existing services, it is superior to S1 to S5, and

inferior to S6 to S9. If the Commission is identifying comparable services for the purpose of imputing a retail price, ie for the purpose of determining the price that Telecom would charge for the service if it offered the service at retail, to which services should it look?

- 4.5 Plainly the most comparable services are S5 and S6, between which the regulated service lies on the relevant spectrum of service quality. If a user was asked to identify the most comparable services, it seems obvious that these are the two that would be selected. The same is true for Telecom, or any competing provider of such services. The Commission's imputed retail price for the regulated service (the retail price that the Commission would expect Telecom to charge for the service, if it were provided at retail, consistent with the observed prices for existing retail services) should lie between the retail prices for S5 and S6. A wholesale discount would then be applied to this imputed intermediate price.
- 4.6 Even if the cost of providing each of the services S1 to S9 was the same, this would not mean that they were comparable as a matter of ordinary language. The cost similarity would not mean that the services would be described as the same by either users (who plainly do not see them as the same, since they are willing to pay higher amounts for some than for others) or providers. It also would not mean that for the purpose of imputing a retail price to the regulated service, it made sense to adopt an approach which gave equal weight to the pricing for each of the nine services, and produced a result lying outside the pricing range for S5-S6. It might be appropriate for the Commission to look at the prices of the other services – but only if it paid attention to degrees of similarity/difference on the factors that drive retail price.
- 4.7 Finally, suppose that the regulated service is the same on most dimensions as the range of services offered by Telecom (S1 to S9), but is superior to all those services on the dimension that is a key driver of pricing for the existing services. If the Commission is identifying comparable services for the purpose of imputing a retail price, to which should it look?
- 4.8 The most comparable service from the perspective of both users and Telecom will be the service that comes closest to the regulated service on the key dimension (since other things are equal) – S9, if that is the highest quality/highest priced service. So the Commission should look to S9 – and impute a retail price to the regulated service that takes into account the fact that it is superior on a dimension relevant to pricing, so would entail a higher retail price than S9, if Telecom were to offer it at retail.
- 4.9 In this example it may also be appropriate for the Commission to look at some or all of the other services in the range (ie S1 to S8). But the process of imputing a retail price to the regulated service would then need to take into account the dimension on which these other less comparable services are inferior, and

generate a coherent set of prices for the existing services and the regulated service having regard to the differences between them.

- 4.10 Where the regulated service is a component of the services supplied at retail by Telecom, rather than the entire retail service, the process of identifying comparable services is obviously a little more complex. But the basic point remains that the comparator services must be selected by reference to the dimensions that drive retail pricing, and not by the (entirely irrelevant, as a matter of ordinary language and policy) cost of provision of the services.
- 4.11 As noted above, focusing on service dimensions that drive retail pricing is consistent with the purpose for which comparator services are being selected, which is to impute a retail price for bitstream services excluding data transmission and other services bundled with Telecom's Jetstream offerings. If Telecom provided a retail Jetstream service that was in all respects identical to the unconstrained service that the Commission proposes to require Telecom to wholesale, then all that would be needed in order to impute a retail price for the regulated service would be to back out the elements of the price that relate to services other than the bitstream service. It seems clear that:
- 4.11.1 such a service would, for any given data cap, be priced higher than the corresponding speed-restricted Jetstream services currently offered by Telecom – say \$x;
- 4.11.2 in order to impute a retail price for the unconstrained regulated service, it would be necessary to adjust the price of the unconstrained Telecom retail service downwards to exclude data transmission etc, while preserving the element of the retail price that reflects the directly comparable speed of the connection. Backing out the speed premium included in \$x would be inappropriate, since the same downstream speed is a feature of the regulated service. A substantial component of the imputed retail price after the appropriate adjustments is likely to be the speed premium for an unconstrained speed service;
- 4.11.3 unless proper attention is paid to the speed premium, the imputed retail price will not be consistent with the observed retail pricing in this market.
- 4.12 One more example may shed some light on the situation where price is determined by two key factors, rather than one. Suppose (simplifying a little) that the price of serviced apartments in a city depends on capacity (whether the apartment sleeps 1, 2, 3, 4 etc) and quality of fit-out. Suppose you are the manager of a new high quality serviced apartment hotel, and you need to set prices for the apartments in your hotel before opening for business. The owner asks you to gather information about prices in other apartment hotels, and set prices based on comparable apartments in those other hotels. What would

“comparable” mean, in this context? It could only mean, comparable on the dimensions that drive pricing in those other hotels – ie, capacity and quality. No customer would say that two apartments were comparable merely because they slept the same number of people, if they were of very different quality; or (conversely) because they were of the same quality, if they slept different numbers of people.

4.13 If you focus on one pricing dimension only, and use an average price of all the city’s 2 person apartments to set the price for your 2 person apartments:

4.13.1 you have not in fact followed the instruction to base prices on *comparable* apartments. Some (the high quality ones) will be comparable, but many will not, because you have ignored a key dimension which drives pricing;

4.13.2 the price you end up with will not be a sensible price for the high quality 2 person apartments you are offering – you have not achieved the goal of setting (imputing) an appropriate price for the service you provide, because you have ignored the fact that price is influenced by quality as well as capacity.

4.14 In summary, therefore:

4.14.1 the services to *which* the Commission has regard must be comparable on all dimensions relevant to the setting of retail prices;

4.14.2 it is wrong in law to have regard to retail prices for services which are not comparable on dimensions relevant to the setting of retail prices, even if the services are *comparable* on dimensions relevant to the cost of providing the service;

4.14.3 likewise, it is wrong in law to fail to have regard to the retail prices for the service or *services* which are most similar to the regulated service to be provided to the access seeker. The Commission’s starting point must be the retail prices for the service or services that are most similar to the regulated service on dimensions relevant to retail pricing;

4.14.4 if the retail pricing of a service by Telecom is significantly influenced by the downstream speed of the service, then the “comparable service” to which the Commission has regard must be comparable to the regulated service in terms of downstream speed. The Commission would err in law if it disregarded the prices of services that are most comparable in terms of speed, and based its calculation solely (or even equally) on the retail prices of services that are less comparable on this key dimension than those that were disregarded;

- 4.14.5 likewise, if the pricing of a service is significantly influenced by whether the end user is a residential or a business user, then the “comparable service” to which the Commission has regard must be comparable to the regulated service on this dimension. If this distinction is a material driver of pricing, the *Commission* would err in law in basing its calculation of an imputed retail price on plans that do not correspond to the regulated service on this dimension.
- 4.15 The Commission has in the past recognised that different downstream speeds define different services, and thus implicitly that services with materially different downstream speeds are not comparable, as required for the purposes of the IPP. The Commission’s statement of 10 September 2004 on the interaction between the regulated bitstream service under the Act and Telecom’s commercial bitstream service notes, at para 6: “For example, a bitstream service with a different downstream speed would not be the same service.” It would be inconsistent (as well as wrong in principle) for the Commission to treat services with different downstream speeds as different services for the purpose of s 22, but as the same services for the purposes of applying the IPP.
- 4.16 The Commission has also recognised in its previous work that a speed premium is a feature of Telecom’s retail prices: see the “Correction of Business Bitstream Access Calculation” of 27 April 2005, paras 7 – 12. When adjusting the observed retail prices to impute a price for the regulated service:
- 4.16.1 the Commission should not back out the speed premium, since the fast speed remains a feature of the wholesaled service;
- 4.16.2 to the contrary, the IPP requires the Commission to add an additional premium to the observed retail prices to reflect the still greater speed provided by the regulated service.

5 Interpreting the IPP: scheme and purpose of the legislation

- 5.1 The IPP must be interpreted in a way that is consistent with the scheme and policy of the legislation. The meaning it is given must support, and must not impede, the policy objectives of the legislation. That policy must be discerned from the language of the provision, read in context; from the purpose provision in s 18; and from relevant background materials such as the Fletcher report, the Commission’s LLU report, and parliamentary materials.
- 5.2 The central feature of the statutory scheme for present purposes is the adoption of a “retail minus” approach in the context of the IPP. The starting point for setting wholesale prices for this service is not Telecom’s cost of provision of the service. Rather, it is Telecom’s observed retail prices.

- 5.3 The reasons for adopting this approach, and providing for wholesale prices to be set by applying a discount to relevant retail prices, include:²
- 5.3.1 a concern not to deter investment by preventing recovery of returns that will fund such investment. Preventing price discrimination would risk driving down returns to a level that does not support an optimal level of investment. A “retail minus” approach is intended to be consistent with continued price discrimination by the incumbent, on dimensions that are not relevant to costs – this is perhaps the most basic difference between retail minus and cost-based price regulation;
- 5.3.2 recognition of the importance of the regulated firm being able, in these areas, to set charges according to its commercial judgment (a related point, but one that is so important it deserves some emphasis). Imposition of retail minus pricing is intended to permit entry by resellers without requiring the regulated firm to depart from what it considers to be the commercially optimal pricing for its retail services. Put another way, the purpose of retail minus regulation is to control the margin between retail and wholesale prices, not the absolute level of prices;
- 5.3.3 a desire to enable other service providers to buy the relevant services at wholesale and resell them at retail, in particular where they add value by themselves supplying other components of the retail service – but without impairing the incumbent’s investment incentives and pricing discretion, as explained above. This means that the main competition policy concern in this field is preventing “price squeezes” between retail prices (as set by the incumbent – not *by* the regulator, and not necessarily based on cost) and wholesale prices. Hence “retail minus” – the idea is to start with the actual retail prices set by the incumbent, whatever they may be and however they may be structured, and to subtract from those prices the costs that are avoided as a result of selling at wholesale rather than at retail (or, in the IPP context, an estimate of those costs expressed as a percentage of the retail price).
- 5.4 It is essential, if these goals are to be achieved, that the services referred to for the purpose of identifying relevant retail prices are as similar as possible to the regulated service on all dimensions that drive retail pricing. Otherwise the intended relationship between retail prices and wholesale prices is lost, the ability of the incumbent to set profit-maximising retail prices and so fund investment is

² For the rationale for retail minus pricing see LLU Report paras 481, 812; Ofcom Review of Wholesale Broadband Access Markets, paras 4.46-4.50, esp para 4.49, and 4.71-4.73; Irish Commission for Communications Regulation, “Consultation on Retail Minus Wholesale Price Control for the WBA Market”, 19 August 2005, paras 3.2 ff, 4.10 ff.

impaired, and the policy rationale for selecting retail minus regulation rather than cost-based regulation will be frustrated.

- 5.5 Suppose for example that the incumbent firm provides services S1 to S9 at prices that vary significantly with quality, even though the cost of delivery of the various levels of service is not materially different. (This is common in all markets where pricing is based primarily on value to users rather than on cost of provision – consider for example software licensing, where different licence fees apply to businesses depending on the number of users, even though there is no additional cost to the licensor in permitting the software to be used by additional users. Airline ticket pricing is another common example of a value-based approach to pricing – two passengers seated beside each other, in respect of whom the airline will incur precisely the same costs of service, often pay very different prices depending on when they booked their flight and certain other cost-unrelated factors.)
- 5.6 A cost-based approach to regulation of these services would result in essentially the same wholesale price for each level of service, if the level of service does not materially influence cost (I understand there is some dispute about this, but will proceed on this basis for the purposes of this advice). This in turn would lead to retail prices converging, as resellers pay the uniform price for the service and seek to attract the higher value users – the premium for quality will be competed away. The incumbent will also have to drop the prices of the more expensive services in response to this competition – the pre-regulation price discrimination will not survive resale at a uniform wholesale price. (In other words, as Professor Hausman has explained, price discrimination cannot survive arbitrage of the kind that would be permitted by the Commission's proposed approach.)
- 5.7 Retail minus pricing of wholesale services, on the other hand, is intended to enable the incumbent to retain their existing pricing structure while also enabling access seekers to purchase the services at wholesale and compete on the retail margin, and on added value services. This can only be achieved if the wholesale price closely reflects the existing quality-driven pricing differences at retail.
- 5.8 It is fundamentally inconsistent with the policy rationale for adopting a retail minus approach to select comparator services by reference to cost of service. If the regulator is seeking to set a wholesale price for a regulated service which is provided by the incumbent at a low retail price (S1, say) and takes as the comparator a high-priced service with similar costs (S9, say), the wholesale price selected will be too high – it will not enable an access seeker to provide the regulated service in competition with the incumbent. Obviously this would be a mistake, and would not be consistent with the policy rationale for the regulatory regime.

5.9 The converse is equally true, though perhaps less starkly so. If the regulated service is of the same (or better) quality than S9, taking the retail price of S1 as the starting point for setting a wholesale price for the regulated service will give the access seeker a wholesale price for the regulated service at a discount far greater than the retail margin. Access seekers will begin by offering lower prices to the current purchasers of S9 (and other high-quality services). The incumbent will have to respond, or lose all high value customers to access seekers. Over time (and probably, quite quickly) prices for the high quality services will be driven down towards a price reflecting a retail margin over the wholesale price based on the price for S1. That is, the entire price discrimination structure will become unsustainable, and will unravel – contrary to the original rationale for adopting a retail minus approach.

6 Inconsistency of suggested approach with the legislation

- 6.1 In my opinion it is very clear that the Commission's approach to setting a wholesale price for an unconstrained service is wrong in law. This can be put in a number of ways: in essence, the Commission has misdirected itself on a question of law, and as a result it has failed to have regard to relevant matters, in particular the dimension of speed when selecting comparable services for the purposes of the IPP.
- 6.2 More concretely, this error of law/misdirection has led the Commission when applying the IPP to fail to have regard to relevant matters (the price of high speed business plans) and to have regard to irrelevant matters (the price of low speed residential services).
- 6.3 The essential error is that the Commission has not, when selecting comparable services for the purposes of the retail minus analysis in the IPP, asked whether the regulated service is *comparable* to the selected services *in terms of the factors that determine retail pricing*. Instead, the Commission has looked to costs of service to identify comparators.
- 6.4 The Commission should either:
- 6.4.1 have had regard only to the most comparable service – the highest speed, highest priced business plan; or
 - 6.4.2 have had regard to a wider range of services, but given them differing weights as comparators taking into account how similar they are on the quality/speed dimension. So the imputed price would more closely reflect the retail prices of the (more comparable) higher speed services.
- 6.5 In other words, the Commission should have selected comparators and imputed a price for the regulated service in a manner which recognised that speed is a significant driving factor for price. Ignoring downstream speed in this context is

like ignoring quality of apartments in the hotel example in paras 4.12 to 4.13 above, and setting prices based solely on the size of apartments. Both the selection of comparators, and the comparison/imputation process, departs from what the legislation intended if key drivers of retail price are not taken into account at both stages.

- 6.6 The Commission's use of all the residential Jetstream services as the comparable services when applying the IPP, and none of the business services, makes no sense as a matter of ordinary English. No business user would regard a low speed residential service as comparable to the service that they currently receive, or (the relevant test) to the service that an access seeker would be able to provide using the proposed regulated service. The business user would, if asked, say "no, that service is not comparable – it is a very different service" – a point that the Commission itself has made in another context (see statement of 10 September 2004, para 6, referred to in para 4.15 above).
- 6.7 Setting a wholesale price for a high quality service based on the retail prices of a mix of services including much lower quality services, and without taking into account the higher speed/quality of the regulated service as compared with the comparator services, is also inconsistent with the policy rationale for using retail minus pricing in this context: see para 5.9 above. It would inevitably lead, over time, to pressure on Telecom's retail pricing in relation to the regulated service, and would unravel the current price discrimination regime, to the detriment of consumers.
- 6.8 The reason given by the Commission for disregarding the most comparable services when selecting data for use in its analysis is in my view particularly unsatisfactory. The business plan data have not been used because the particular form of regression used by the Commission does not provide reliable results when these plans are included. The appropriate response in such circumstances is to continue to use the relevant data, and to identify a different and more robust method for using those data to impute a retail price for the regulated service: the inadequacy of one analytical tool to handle the most relevant data is not a reason to ignore those data. To allow the choice of regression methodology to determine which data to analyse is entirely back to front. The starting point must, as the Act requires, be retail prices for comparable services. And for all the reasons set out above:
- 6.8.1 the services must be comparable on the key determinants of retail pricing;
and
- 6.8.2 the imputation of a retail price for the regulated service must take into account the variation of price by reference to those determinants.

7 **Single service/single price versus multiple services/prices**

- 7.1 There is another very important and closely related respect in which the Commission's proposed approach is not consistent with the Act. The Commission has decided to require Telecom to provide a single, unconstrained service (with a downstream PIR at the maximum technical capacity of the DSLAM), at a single price. But the Commission does not appear to have considered whether this is more or less efficient than requiring Telecom to provide a number of regulated services at different speeds and different prices, as required by s 18(2) of the Act.
- 7.2 The Commission has rejected Telecom's preferred approach of providing for regulated services that mirror precisely the commercial bitstream services provided by Telecom. In my view that is an option that is open to the Commission under the Act, and there appears on first impression to be some force in the Commission's reasoning that other providers should be free to provide services with characteristics that differ from Telecom's services (draft determination paras 162, 163). But there are two problems with the way in which the Commission has approached this issue:
- 7.2.1 the Commission has not carried out the comparative efficiency analysis required by ss 18 and 19;
- 7.2.2 the Commission has leapt from a decision not to mirror Telecom's services exactly (which may well make sense) to specifying as the regulated service a single service with a single price. It has not considered other options such as providing for a set of regulated services in speed "bands", with different prices for different bands. The highest band could extend to the maximum technical speed available, if this is consistent with the relevant access principles (on which I express no view). The relative efficiency of this approach should also have been considered.
- 7.3 Under the Act the Commission cannot decide to adopt a single service/single price approach without considering the efficiencies of that approach. Section 19 mandates consideration of the goal of promoting competition in telecommunications markets for the long term benefit of end-users of telecommunications services in New Zealand. Section 18(2) provides that in determining whether or not, or the extent to which, any act or omission (eg adopting a single service/single price approach) will serve that goal, the likely efficiencies that will result must be considered. So when deciding whether to adopt a single service/single price or multiple service/multiple price approach, the Commission is required to consider the efficiencies of selecting one approach over the other.

- 7.4 Failure to perform this (mandatory) efficiency analysis is inconsistent with the statutory requirements in ss 18 and 19, and would render any resulting decision unlawful and invalid.
- 7.5 This issue is very closely related to the IPP application issue. If the Commission had adopted a banded approach, for example, it could then have looked to comparable retail services for each band, and based its pricing for each band on the corresponding retail prices. Correcting one error would facilitate correction of the other, and would not in any way compromise the Commission's desire to enable other service providers to provide services differing from Telecom's, including (if otherwise appropriate) an unconstrained service. But the pricing for such a top band service would need to be calculated by reference to comparable services ie Telecom's higher speed services, with adjustment for (among other things) any superiority in speed over and above Telecom's existing best quality offering.
- 7.6 Another reason that the issues are closely related is that carrying out a proper efficiency analysis depends on how prices are set for the single and multiple services. If the Commission requires provision of a single unconstrained service, that would necessarily be relatively highly priced compared with lower speed services, if a proper approach is adopted to identifying comparable services and imputing a retail price for the regulated service. There is likely to be much lower uptake of such a service than there would be of a range of regulated services, some of which would provide lower speeds but at lower prices. Such an outcome would have significant implications for the required efficiency analysis.

8 Common-sense overview

- 8.1 It is helpful to carry out a simple common-sense cross-check to see whether the Commission's approach will deliver the competitive outcomes that Part 2 of the Act and the IPP are intended to achieve. Suppose the access seeker decides to offer retail services that correspond closely to Telecom's current retail offerings: will the access seeker face a price for the component purchased from Telecom which represents a 16% wholesale discount on Telecom's retail price for that component, enabling them to compete on that margin so far as the wholesaled component is concerned, and to compete on their relative efficiency as a provider of other components of the overall retail service?
- 8.2 It is immediately apparent that this will not be the case if the proposed approach is adopted. Take, for example, Telecom's Broadband Business 3GB service, with a downstream speed up to 1Mbps. The monthly retail price charged by Telecom for this service is \$119.95 (excluding GST). Under the proposed approach, Telecom would be required to wholesale a faster bitstream service for \$26.57, which the access seeker could use as an input into a retail service for business customers with the same monthly data cap of 3GB, but faster speeds – ie a superior retail service.

- 8.3 The Venture 3GB service provides the same monthly data cap as the Jetstream Business Broadband 3GB service, but a much lower downstream speed of 256 Kbps. It retails for \$79.95 per month. This figure represents an upper limit for the element of the price charged for the Business Broadband 3GB service that represents data transmission charges and ISP charges, since these features do not vary between the two schemes. (It is of course an overestimate, as part of the \$79.95 figure also represents a charge for bitstream services.) Thus the retail price of the relevant component (bitstream access) for the Business Broadband 3GB service is in excess of \$40, on any view.
- 8.4 The access seeker would, on the proposed approach, pay a wholesale price of \$26.57 for the bitstream access component of its own retail 3GB service. This price gives the access seeker a discount in excess of 33% from the comparable retail price for an inferior service. This goes far beyond what is intended by the statutory regime, even before adjusting for the superior speed of the regulated service.
- 8.5 Similar results are likely to be reached for all the business Jetstream services. If the access seeker uses the regulated service only to provide high speed business connections, the pricing difference between wholesale and retail services will be dramatically different from what was intended by the framers of the legislation when adopting a "retail minus" approach.
- 8.6 Discounts of this magnitude also raise serious efficiency questions. It seems likely that rather than facilitating entry and competition on relevant dimensions, the Commission's proposed approach risks eroding pro-competitive price discrimination and harming efficiency. A full analysis of the efficiency implications of discounts of this magnitude (and the likely market impact of wholesale prices structured in this manner) would be required by s 18, were it not for the fact that such an approach fails the more fundamental test of consistency with the legislation.
- 8.7 The banded approach suggested above would, by contrast, deliver the sort of competitive environment envisaged by the legislation. The s 18 test would of course still need to be applied, but seems more likely to be satisfied.

9 Next steps

Engaging with the Commission on these issues

- 9.1 The Commission has not yet made a final decision on these important issues, which are central to the effective operation of the retail minus regime. Although these issues have been canvassed in some detail in previous Telecom submissions, I am sure that the Commission will give careful consideration to any further material that it receives which may help it to perform its regulatory responsibilities consistently with the statutory framework under which it operates. For this reason, I suggest providing this advice, or a summary of it, to the

Commission. I would also be happy to discuss these issues with the Commission's legal advisers.

9.2 It seems to me that there are three possible outcomes from this process:

9.2.1 the Commission agrees with the reasoning in this advice, and modifies its proposed approach accordingly. This would ensure that the concerns identified in this advice are avoided;

9.2.2 the Commission is not fully persuaded, but accepts that there is real doubt about these matters of law; or

9.2.3 the Commission considers that this advice is clearly wrong, and that its proposed approach is clearly consistent with the Act.

Commission power to state a case to the High Court

9.3 If the Commission concludes that there is real doubt about whether its proposed approach is consistent with the Act – and it seems to me that this at least must be the case – then it would in my view be wrong for the Commission to press ahead with the proposed approach before that legal issue is resolved. The Commission has been given the power to state a case to the High Court in relation to matters of law which arise before it under the Telecommunications Act 2001 – see s 15(j), applying s 100A of the Commerce Act 1986. This recognises that the Commission's expertise is in matters of competition policy and practice, not law: if the Commission is in real doubt about the lawfulness of its proposed actions, it should state a case to the High Court, which is the body with the relevant expertise.

9.4 This is precisely the sort of situation for which the case stated power has been given to the Commission – if it would not use it here, when would it use it? I note that in my view the time required to state a case and have it determined by the Courts is not a reason to refrain from exercising the power, for two reasons:

9.4.1 first, if the issue is urgent, the Courts will deal with it on that basis. A very focused and confined matter of the kind considered in this advice could be heard and determined within a few months from filing proceedings, if the Court agreed that it was genuinely urgent;

9.4.2 second, Parliament must have considered that in cases where the Commission is in real doubt about significant matters of law under the Act it would be appropriate to refer those matters to the Courts for determination even though this would inevitably take longer than the Commission simply itself taking a view, with the benefit of legal advice. Otherwise the case stated power would not have been expressly extended to this Act.

- 9.5 As a responsible statutory body, the Commission is required to give careful consideration to whether or not to exercise its power to state a case in the present circumstances. I am sure that it will do so. (I note that a decision not to exercise a power is reviewable in the same manner as a decision to exercise a power: in the leading case *Padfield v Minister of Agriculture Fisheries and Food* [1968] AC 997 the decision that was reviewed, and set aside, was a decision by a Minister to decline to exercise a statutory power to refer a complaint to a committee for investigation.)
- 9.6 I suggest asking the Commission to state a case, and to give reasons if it declines to do so.
- 9.7 Once an urgent decision had been obtained from the High Court, it would be proper for the Commission to proceed to issue its determination, whether or not there was an appeal by any party. There could be no criticism of the Commission for proceeding to a determination on the basis of an interpretation approved by the High Court, even if an appeal were pending.
- 9.8 For the sake of completeness, I note that there are other procedural options for resolving this issue in advance of a final determination, such as the Commission applying for a declaration (as it did in the recent Fonterra litigation), or cooperating with an application for a declaration made by Telecom. I have not yet had the time to consider the procedural advantages and disadvantages of these options, but will provide further advice on this point.
- Options if the Commission declines to state a case*
- 9.9 If the Commission takes the view that there is no real doubt on these issues of law, and declines to state a case to the High Court or apply for a declaration, then Telecom will need to decide whether to seek to have these matters determined before any decision by the Commission, in urgent judicial review proceedings, or to await the final decision and then either appeal, or seek judicial review, or both.
- 9.10 Section 60(3) of the Act appears to prevent the grant of interim relief which would prevent a final determination by the Commission having effect pending a decision by the Court on an appeal, or judicial review. So if a determination is issued, it will come into effect, and the access seeker will be able to purchase the regulated service on the prescribed terms unless judicial review proceedings are heard and determined urgently, as discussed below.
- 9.11 I understand that if the determination comes into effect this is likely to have significant, and probably irreversible, market impacts. In terms of technical characteristics of services, and pricing structures, it may not be easy to put the genie back in the bottle following a successful appeal. On price, however, my preliminary view is that Telecom probably would not be left without a remedy. It seems to me that there are two possible mechanisms through which a finding that

the Commission had erred in law could be given retrospective effect, and the price for an unconstrained service significantly increased above the level proposed by the Commission.

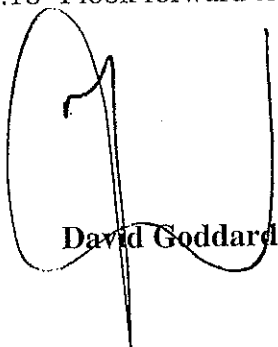
- 9.12 One mechanism would be judicial review proceedings seeking to have the decision set aside with retrospective effect: for the circumstances in which the Court will make such orders, see *Murray v Whakatane District Council* [1999] 3 NZLR 276; *Martin v Ryan* [1990] 2 NZLR 209; *A J Burr Limited v Blenheim Borough Council* [1980] 2 NZLR 1 (CA). Telecom could then seek payment from the access seeker on a quantum meruit basis.
- 9.13 The other mechanism depends on whether the recent High Court decision on retrospectivity of pricing review determinations is correct. If that decision (which I understand is currently being appealed by Telecom) were to be upheld on appeal, then any guidance from the Court on appeal/judicial review would have to be taken into account in a pricing review determination, with retrospective effect. If the Commission does issue a final determination on the proposed basis, Telecom could seek a pricing review, and appeal (or seek judicial review). The Court would decide the question of law, and the Commission would then be required to apply the interpretation approved by the Court in carrying out the pricing review.
- 9.14 Through one or other of these mechanisms, there is a real prospect that the price for the Commission's proposed regulated service would be substantially increased retrospectively – potentially by well over one hundred percent. The risk of this is a factor that the access seeker would need to take into account in deciding whether or not to purchase the regulated service, rather than one of Telecom's existing commercial offerings. (Telecom should expressly put the access seeker on notice that it will be seeking retrospective adjustment to a substantially higher speed-related price.) There must be a real prospect of the access seeker not taking up the service, or doing so in a more limited manner than would otherwise be the case, in the light of this risk. I doubt this is an outcome that the Commission would see as desirable, or that is consistent with the statutory scheme – this only serves to underline the desirability of stating a case to the Court to resolve the matter before any final determination.
- 9.15 The other possibility, on which I will provide further advice, is an urgent judicial review application by Telecom to the High Court for a decision on the issue before any final determination by the Commission. In my view it is likely that the Court will be reluctant to grant interim relief delaying or preventing the issue of a determination, other than in exceptional circumstances, having regard to the statutory scheme. But the unavailability of interim relief staying or suspending a determination *after* it is issued points strongly towards effective intervention in appropriate cases *before* a determination is issued, if the determination is unlawful and will have serious adverse consequences – probably by directing an urgent

hearing, and perhaps also, in appropriate cases, by granting interim relief for a short period to enable the matter to be determined urgently.

9.16 As noted above, the very confined nature of the issues that would be raised in such proceedings means that they would be ready for trial very quickly indeed, and could be heard and determined in a matter of a few months. The recent judicial review proceedings brought by Contact and Meridian against the Electricity Commission were filed in April, and heard and determined in August. Those proceedings were more complex than the present case, and featured two contested interlocutory hearings and discovery. This case should be faster still: no discovery would be required, and there is less scope for contested interlocutory applications (in the Electricity Commission case, most of the interlocutory argument concerned discovery matters).

9.17 The serious adverse consequences of the errors of law that have been identified, the unavailability of interim relief suspending a final determination after it is made, and the ability to try the case very swiftly, together mean that an urgent hearing would in my view be feasible and appropriate. If proceedings are filed in the near future and are heard urgently, a decision should be able to be obtained before any final determination comes into effect.

9.18 I look forward to discussing these matters further with you



David Goddard