

David Goddard QC

Thorndon Chambers

PO Box 12016
Wellington
NEW ZEALAND

11th Floor
Vogel Building
Aitken Street

Tel: (64 4) 499-6040

Fax: (64 4) 499-6118

e-mail: david.goddard@chambers.co.nz

Memorandum

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

DATE: 25 November 2005

BITSTREAM ACCESS APPLICATION: COMMENTS ON OPINION FROM MR FARMER QC

- 1 In this memorandum I clarify some aspects of my earlier opinion that appear to have been misunderstood by Mr Farmer QC, and respond to the suggestion that my conclusions are based on factual assumptions that, on Mr Farmer's instructions, are not correct.
- 2 Mr Farmer's opinion of 21 November 2005 addresses, among other issues, whether the concerns identified in my earlier advice can be addressed in judicial review proceedings before the Court. I will not respond to that aspect of his advice: the purpose of this note is to assist the Commission in its decision-making, not to anticipate the issues that will be canvassed in the pending interlocutory applications in Telecom's judicial review proceedings.

One service, or a range of different services?
- 3 Mr Farmer attributes to me the proposition that the Commission should have provided for regulated services that mirror precisely the commercial bitstream services provided by Telecom.¹ Large parts of his advice are based on the assumption that this is my view, and that this view underpins my conclusion that the Commission's proposed approach is wrong in law. That is not correct.
- 4 The proposition set out above reflects Telecom's preferred approach. But as I said in my advice, the Commission has rejected that approach; that is a decision that is open to the Commission; and there is some force in the reasons it has given

¹ Opinion of 21 November, para 3(6), referring to para 7.2 of my advice of 3 November.

for doing so (see para 7.2). I identified other options open to the Commission, such as providing for a set of regulated services in different speed bands.

- 5 The Commission therefore has a very important decision to make on what services, with what features, it will require Telecom to provide. The Commission has to choose between:
 - 5.1 requiring Telecom to provide a range of services with different features (in particular, different downstream speeds – which could include, subject to technical issues, an unconstrained downstream speed service), at different prices; or
 - 5.2 requiring Telecom to provide a single service, with certain defined features, at a single price.
- 6 This is perhaps the most important choice that the Commission needs to make in deciding what the regulated service, or services, should look like. But the first of these options is not identified by the Commission as an option open to it, or developed in any way, and there is no discussion of the relative merits of the two approaches.
- 7 The misunderstanding identified above means that Mr Farmer is setting up a straw man in his second question (para 11). I am not suggesting that the features of the regulated service/services need to track precisely the features of the retail services currently offered by Telecom, in particular in terms of downstream speed. My point is that the retail minus approach in the Act requires the *pricing* of the regulated services (whatever they may be) to be consistent with the pricing of Telecom's current retail services, having regard to the features of the bitstream service that drive retail pricing. (Mr Farmer appears to agree with this proposition in principle, but says that on his instructions, downstream speed is not a feature of the regulated bitstream service. I address this suggested factual disagreement below.)

The required efficiency analysis

- 8 The choice between the two approaches described in para 5 above is the choice which I say should be subjected to an efficiency analysis, as required under ss 18 and 19. The Commission has to compare the relative efficiency of these approaches in order to decide which decision would *best* give effect to the s 18 purpose (s 19(c)). But because the Commission has not identified this as a choice it must make, and indeed has not identified the first of these approaches as an option, it has not carried out or consulted on an efficiency analysis of the two approaches.

- 9 Mr Farmer suggests (para 26) that my “complaint” is that the Commission should undertake an efficiency analysis “which compares the proposed single regulated service with *each* of Telecom’s product offerings” (emphasis in original). I am not sure what this suggestion is based on, but I am happy to clarify that it is not correct. Sections 18 and 19 require the comparison to be between the efficiency consequences of the two decisions open to the Commission: a single regulated service with a single price versus multiple regulated services at multiple prices. The comparison has nothing to do with Telecom’s product offerings, let alone each of them.
- 10 This comparison also differs from the efficiency analyses which Mr Farmer identifies, in subparas (a) and (c), as analyses which the Commission has at various times carried out. If (as I consider) the Commission is required to consider the relative efficiency of the two approaches identified in para 5 above, it is no answer to point to efficiency analyses of entirely different issues.
- 11 Mr Farmer also suggests (para 26(b)) that it can be inferred from the timeframes prescribed by the Act that it was not intended that the Commission carry out a full cost benefit analysis of the choice it makes. However:
- 11.1 my basic point is that there has been no analysis, qualitative or quantitative, of this very significant choice;
- 11.2 similarly, the Commission has not consulted on its methodology (including whether to do a qualitative or quantitative analysis, and if the latter, how it should be performed);
- 11.3 if additional time is required to make decisions under the Act, the Commission has – and has already exercised – the power to extend the relevant timeframes.

Downstream speed is a feature of the regulated service

- 12 This leads to the next question raised by Mr Farmer, of whether downstream speed is a characteristic of the regulated wholesale service. Although Mr Farmer suggests there is a factual issue here, and that his instructions suggest I have proceeded on the basis of an incorrect factual assumption, I doubt that this is correct.
- 13 It appears to be common ground that:
- 13.1 Telecom will provide the regulated service using its DSLAMs;
- 13.2 the ports on the DSLAMs can be set to different speeds, including a setting of “no speed constraint”;

- 13.3 when Telecom provides retail or wholesale services at different speeds, it sets the ports on its DSLAM accordingly.
- 14 There are two reasons why it is not, in my view, plausible to suggest that downstream speed is not a feature of the regulated service, or even to suggest that there is a factual disagreement on this point.
- 15 The first, and most fundamental, reason is that the regulated service is defined in the Act by reference to (among other core features) its downstream speed. The service Telecom is required to provide is a bitstream service which “requires a downstream throughput rate for data traffic sent to the end-user that must (i) not be less than 32 kbps; and (ii) have an average of not less than 256 kbps”. So the suggestion that downstream speed is not a characteristic of the regulated wholesale service is quite simply inconsistent with its statutory definition: downstream speed is one of its defining characteristics, as a matter of law.
- 16 The second reason is that TelstraClear has asked the Commission to require Telecom to provide a wholesale service using its DSLAMs with each relevant port set to “no speed constraint”. TelstraClear is not indifferent to this feature of the service – it has expressly requested it. And on the Commission’s proposed approach, this would be a mandated feature of the (single) regulated service.
- 17 My instructions are that there are other methods for retailers to set speed constraints on a broadband service, and that there are other downstream consequences of the speeds that are offered to end users in terms of required transmission capacity. In particular, retailers can further limit (but cannot increase) the speed set by means of the DSLAM port. I do not understand there to be any difference between my instructions and Mr Farmer’s on these issues.
- 18 But the ability of retailers to constrain speeds further, and the downstream consequences of different speed settings, are irrelevant: the key point is that the downstream speed setting of “no speed constraint” is a feature of the bitstream service that TelstraClear seeks, and that the Commission proposes to require Telecom to provide.
- 19 Considerable time and effort has been devoted by the parties and the Commission to the question of speed settings, precisely because this is a feature of the bitstream service to be provided by Telecom, and it has a very important impact on the features of the retail service that can be offered using that bitstream service – it sets the upper speed limit for that retail service. TelstraClear wants the Commission to require Telecom to set the DSLAM ports to “no speed constraint”. It is inconsistent for TelstraClear to press strongly for a particular speed setting of the ports as a feature of the regulated service in the “technical” context, while arguing in the pricing context that it is not the case that the bitstream component

“in whole or substantial part, determines or conditions the speed of the retail product” (cf opinion para 17).

- 20 As I noted in my earlier advice (at para 4.15), the Commission has also previously expressed the view that wholesale services operating at different speeds are different services, for the purposes of the Act. This assumes that speed is a feature of the relevant wholesale service, excluding non-bitstream components.

Downstream speed is a significant driver for retail prices

- 21 I do not understand how it can be suggested that the downstream speed setting of the port is not a significant driving factor for price. This is obvious from a comparison of Telecom’s different retail offerings. For example, in section 8 of my earlier advice I identified two services that differ only on speed, with the faster 1Mbps service costing \$119.95 per month (excl GST) and the slower 256kbps service costing \$79.95 per month (excl GST).
- 22 A graph is attached to this advice which shows how prices of business broadband services vary with speed. The relationship between speed and price is plain.
- 23 The same graph shows how the wholesale prices charged by Telecom for commercial unbundled bitstream services (“CUBS”) vary with speed. These services are very similar to the wholesale bitstream services under consideration in the application before the Commission. They include the same components of broadband services included in the regulated service, and exclude the components of retail services that must be “backed out” of those retail services to arrive at the regulated service. The only material difference is that the applicable downstream speeds are constrained. Telecom’s wholesale bitstream services are differentiated by speed, and higher speeds attract higher prices.
- 24 Thus it seems reasonably plain that:
- 24.1 the wholesale service Telecom is required to provide under the Act can be supplied at different speeds;
 - 24.2 the speed at which the service is supplied is a feature of the service which the Commission needs to decide;
 - 24.3 the Commission could require Telecom to provide a single service at a single specified speed setting (including “no speed constraint”), or multiple services with different speed settings (which need not be the same as Telecom’s current retail or wholesale offerings);
 - 24.4 different speed settings result in different prices both for Telecom’s retail services, and for its commercial wholesale services.

The “component” issue

- 25 Mr Farmer agrees with my analysis of the relevance of service features that influence price, where the retail and wholesale services are the same (opinion paras 13-14). He says that the problem with my analysis lies in bitstream service being a component of the retail services offered by Telecom, “and as such it has no actual retail price.”
- 26 Mr Farmer makes much of the complexity of backing out the non-bitstream elements of Telecom’s retail services. I have explained above why backing out these elements does not exclude downstream speed as a feature of the bitstream service: indeed the Act defines the regulated bitstream services by reference to downstream speed, and TelstraClear has argued strongly for a particular speed setting as a feature of the regulated service.
- 27 But there is another, even simpler, path to the same conclusion, since Telecom does in fact sell services that exclude all the non-bitstream elements.
- 28 Telecom supplies commercial unbundled bitstream services at wholesale. Those services do not include any of the components of retail broadband services that are excluded from the regulated service. The price of these services also excludes an allowance for a retail margin (I return to this point later). So we know that if the Commission were to require Telecom to provide a wholesale bitstream service at a downstream speed of 2Mbps, an absolute floor for the imputed *retail* price would be the existing *wholesale* price for this very service of \$172.70 (GST excl). (In fact, the imputed retail price should be higher, as some retail margin should be added back to this wholesale price as part of the imputation process.) It follows that an absolute floor for the price of the regulated service would be 84% of this figure, which is \$145.07 (GST excl).
- 29 If the Commission requires Telecom to provide a regulated service with no downstream speed constraint, this is as good as or superior to the 2Mbps CUBS service on all relevant dimensions. So again, an absolute floor for the imputed retail price is \$172.70 (GST excl), and an absolute floor for the corresponding wholesale price is \$145.07 (GST excl).
- 30 This comparison avoids any need to attribute features to components of Telecom’s retail services. The benchmark service involves the same components as the regulated service. Like the regulated service, it excludes transmission and ISP services. So none of the objections in paras 17 to 21 of Mr Farmer’s opinion are relevant.
- 31 The attached graph is also illuminating from a policy perspective. As I said in my earlier advice (and Mr Farmer has not disagreed with this point), the principal objective of retail minus price regulation is to prevent price squeezes between

wholesale and retail prices. So for each of the speed settings shown on the graph, the regulatory concern is whether the gap between the CUBS price and the corresponding retail prices is large enough to allow an efficient competitor to provide the additional components of a retail service, and earn a retail margin on the resold service (for present purposes, of 16%).

- 32 In order to address this “gap” concern, the most that can be necessary where a regulated service has the same technical characteristics as a CUBS service is to reduce the corresponding CUBS price by an appropriate amount. Note that:
- 32.1 the gap concern can be fully addressed without abandoning speed-related pricing. Indeed speed-related pricing is necessary in order to set appropriate gaps which go no further than backing out the excluded components, plus a retail margin;
 - 32.2 because the CUBS price excludes the ISP and transmission components, the most that is necessary to ensure an appropriate retail margin (and it is an over-estimate, as explained above) is to reduce the CUBS price by the full allowable retail margin of 16%.
- 33 If the Commission requires Telecom to provide regulated services at speeds which are higher than those shown on the graph, the imputed retail price and regulated wholesale prices need to be consistent with the pricing patterns shown in the attached graph, as explained above.

Price discrimination

- 34 I should add, to avoid any further misunderstandings, that my views on the meaning of “comparable service” and on the need for an efficiency analysis do not depend on the correctness of Professor Hausman’s views on price discrimination. The effect of one or other decision by the Commission on efficiency will require a consideration of their implications for price discrimination – but as Mr Farmer rightly suggests, this is a question of economic analysis, not a question of law. The legal issue is whether the Commission has asked the right question, including considering the implications for price discrimination and hence efficiency of each of the two approaches it could take, and has consulted on this analysis. As explained above, it has not to date done so.

Overview

- 35 Stepping back from the detail of this reply, Mr Farmer’s advice proceeds on the assumption of a factual disagreement that does not in fact exist, and attacks arguments quite different from those that led me to my final conclusions. His instructions on the supposed factual disagreement as to whether downstream speed is a characteristic of the regulated bitstream service are inconsistent with the

statutory definition of the regulated service, and with his client's stance on what the technical characteristics of the regulated service should be. Nothing in his opinion affects the views I expressed in my earlier advice.

36 Those views are in fact reinforced by a consideration of Telecom's CUBS pricing, which confirms that:

36.1 different speed settings are a feature of wholesale bitstream services;

36.2 pricing for the wholesale bitstream component is speed-related;

36.3 the floor for the regulated price of an unconstrained speed wholesale bitstream service supplied to business end-users, on a retail minus approach, should be \$145.07 (GST excl). (Lower prices would of course be appropriate for lower speed services, and for services supplied to residential end-users.) The difference between this figure and the figure arrived at by the Commission should give the Commission serious pause.



David Goddard

Business Plan Pricing - Xtra Broadband

