



GOVERNMENT & INDUSTRY RELATIONS
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6 December 2005

Douglas Webb
Telecommunications Commissioner
Commerce Commission
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WELLINGTON

Dear Douglas

UBS regulatory proceedings: updated information on DSL investment impacts

In Telecom's submission on the Statement for Consultation on UBS, we advised that the Commission's approach to pricing rendered it uneconomic for Telecom to further invest in DSL in rural and provincial New Zealand, that we had put on hold further investment in DSL in such areas and were looking at ways in which we could make ongoing investment in DSL economic.

This letter is to advise the Commission of the results of this further investigation into options for making DSL economic in higher cost areas given the Commission's draft.

Analysis of DSL costs

Telecom has been conducting for its own internal investment and marketing purposes a cost study into DSL. This work has further confirmed our current view that the Commission's approach to UBS pricing substantially changes the economics of investing in DSL in a number of areas. In particular we will be changing our investment guidelines for:

1. DSL in rural New Zealand; and
2. DSL in cabinets - this impacts not just in rural areas but in suburban areas generally, including main centres.

Telecom currently has an economic threshold for a minimum number of customers and revenue needed for DSL investment. The mix of expected customers is very important with more profitable business customers or higher speed residential customers being an important contributor to investment thresholds being met. With the Commission's approach a substantially larger number of customers will be needed to justify the fixed cost of a DSLAM, cabinet upgrade or new backhaul as the average revenue and profitability per customer will decline significantly.

The practical effect of this is that we will not make such investments until there is sufficient demand. This will mean a very large increase in 'waiters' i.e. customers wanting to connect but who live in an area where there are insufficient other

customers to justify a capacity upgrade or new broadband installation. In the foreseeable future, in many instances there will now no longer be sufficient profitable demand to justify the investment. In other cases the investment may eventually happen but far later than would have been the case under the commercial UBS approach.

On this basis Telecom has reconfirmed its position that we will continue to sign up new customers where existing DSLAMs or backhaul capacity can be utilised. However, where such capacity becomes fully utilised we will not be making uneconomic investments in either new or larger DSLAMs or more backhaul capacity. Our current calculations indicate this will result in at least 18,000 customers who would have taken broadband by June 2007 no longer being offered service. This number will rapidly grow after that date as existing capacity is utilised.

By way of illustration we have estimated that the most affected areas will be:

1. Rural – Ohakea; Tapanui; Mokau; Motu and Matiere
2. Towns – Wairoa; Patea; Turangi and Morrinsville
3. Cities – Whangarei, Rotorua and Nelson

Telecom is willing to provide substantiation of our costing analysis and investment guidelines to the Commission if requested. In our view the Commission cannot make an informed decision on its UBS determination without understanding these issues as it is clearly not in the long term benefits of end users that the Commission sets a UBS price at a rate which causes Telecom to stop investing or at best delaying significantly investing.

It is also worth noting here that backhaul costs are a major cost driver for DSL based services. Our cost analysis assumes that the SIR/contention ratio is the same as Telecom's retail service. Should this not be the case then the potential cost issues could escalate significantly.

We wish to document clearly and place on the record the outcomes of the Commission's approach to UBS pricing given that once customers will be unable to receive service we would anticipate considerable public concern. It is with extreme reluctance that we make these statements. As a company we have worked hard to achieve widespread availability of DSL and again would urge the Commission to take a pricing approach that will better facilitate ongoing investment.

A Pricing Proposal

As part of our investigation into the impacts of the Commission's UBS approach we looked for a way to ensure DSL investment can be made more profitable in high cost areas. We offer up a further proposal for the Commission in the Annex. This builds on two factors:

1. The trend of Telecom's retail pricing towards simplicity; and
2. Telecom's proposals made to the Commission during the UBS process on how pricing could be developed for the UBS.

Telecom's proposal relates to both wholesale and retail pricing for broadband. While it would not necessarily make DSL economic in all circumstances, it would materially improve the economics relative to the Commission's single price approach. At the same time, very attractive retail prices for customers could be delivered. Even so, Telecom may still need to consider a differentiated service or price offering for customers in higher cost areas. Maintaining some price discrimination around speed and value to the user will help minimise such a requirement.

The Commission's pricing approach to DSL has profound implications for customers and Telecom as an investor in infrastructure. We have sought in our interactions with the Commission and the regulatory regime to take a positive approach in terms of implementing the Commission's determinations, even when we have not agreed with them.

In the case of the UBS we believe the impact of the Commission's approach is of such a serious nature that we have taken the steps of documenting what the impacts on customers will be and at the same time putting forward a constructive way forward. In our experience where the regulatory process has worked in conjunction with voluntary offers significant progress has been made.

The contents of this letter are not confidential. However there is a Commission Only and a Public Version of the Annex.

We look forward to a positive response to our proposal.

Yours sincerely



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Government & Industry Relations