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For Ralph Simpson

Telecom and Commerce Commission – bitstream access: wholesale pricing

Instructions

1. I have been asked by you on behalf of TelstraClear to comment on the opinion dated 3 November 2005 provided by Mr David Goddard QC to Telecom and forwarded to the Commerce Commission. Mr Goddard has expressed the view that the Commerce Commission is currently able to be reviewed by the High Court in respect of certain preliminary views that it has expressed – and sought submissions on – in a Draft Determination and Statement for Consultation relating to an application by TelstraClear for the determination of terms (including price) on which bitstream services should be supplied to it by Telecom on a wholesale basis. Under the Telecommunications Act 2001, the Commission is empowered to fix those terms (see sections 20 and 27).
2. Mr Goddard's opinion is lengthy and sets out the issues which he has addressed, the relevant statutory provisions, the history of the application to date, the Commission's reasoning for its preliminary (subject to submissions) views and Mr Goddard's contrary views and reasoning. I will not repeat any of that material here in detail but will assume that the reader of this advice is familiar with the issues and Mr Goddard's opinion.

Summary of Mr Goddard's views

3. Mr Goddard has expressed very strong views to the effect that:

- (1) The Commission's approach to setting a wholesale price for bitstream access for an unconstrained service is "wrong in law". In particular, he says that the Commission has failed to have regard to the price of the retail high speed business plans (a relevant matter) and has had regard to the price of retail low speed residential services (an irrelevant matter).¹
- (2) When selecting comparable services for the purposes of the retail minus analysis in the Initial Pricing Principle in Part 2 of Schedule 1 to the Act, the Commission has been in error by not asking "whether the regulated service is *comparable* to the selected services *in terms of the factors that determine retail pricing*." The Commission, it is complained, "has looked to costs of service to identify comparators".²
- (3) The Commission should have had regard to either the most comparable service, which it is argued is the highest speed, highest priced business plan, or to a wider range of services which includes the business plans, but giving them differing weights as comparators taking into account the degrees of similarity on the quality/speed dimension.³
- (4) The essence of his reasoning is perhaps contained in the view that "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."⁴
- (5) The Commission has failed to consider the relative efficiency of requiring Telecom to provide a single unconstrained bitstream service at a single price, as compared with multiple bitstream services at different downstream speeds and different prices, which he says is required by sections 18 and 19 of the Act.⁵
- (6) The Commission should have provided for regulated services "that mirror precisely the commercial bitstream services provided by Telecom".⁶
- (7) He claims that the effect of the Commission's tentative approach (if confirmed) would be to "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".⁷ In this respect, he expresses concern that the

¹ Opinion paras. 6.1-6.2.

² *Ibid*, para. 6.3.

³ *Ibid*, paras. 6.1-6.3.

⁴ *Ibid*, para. 6.5.

⁵ *Ibid*, para. 1.2.2.

⁶ *Ibid*, para.7.2.

⁷ *Ibid*, para. 6.7.

Commission's approach (again, if confirmed) "risks eroding pro-competitive price discrimination and harming efficiency".⁸

4. At the forefront of Mr Goddard's analysis are sections 18 and 19 of the Act which he says (correctly) set out the criteria which the Commission must apply when arriving at a decision on access terms. Section 18 states that the purpose of Part 2 of the Act and of the relevant Schedules to the Act is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand by regulating the supply of designated telecommunications services between service providers. In this respect, regard must be had to the efficiencies that will result, or will be likely to result, from any act or omission resulting in competition in such markets for the long-term benefit of end-users.
5. I intend no disrespect to him but I will not here traverse every point made in Mr Goddard's opinion or deal with every subsidiary or consequential point that follows from his analysis as I have summarised it above.

Price discrimination

6. Mr Goddard's view that Telecom's pro-competitive price discrimination will be under threat if the Commission proceeds along the lines so far indicated derives some support – and presumably is based upon – evidence before the Commission given on behalf of Telecom by Professor Hausman of MIT. In that report, he points to the well established fact that telecommunications markets are characterised by the existence of significant fixed costs, a fact which leads to a state of imperfect competition and which prevents firms from pricing at marginal cost because of the need to recover their fixed costs. He says that the preferred solution to this dilemma is for firms to follow a policy of price discrimination by charging different price depending on customer segment price elasticities, a policy he says (correctly) that would apply irrespective of whether the firm has market power.⁹
7. I should say immediately that all of this so far is uncontroversial. However, the real issue is whether Mr Goddard (and Professor Hausman) are correct in concluding that the effect of the Commission's preliminary approach to the pricing of the bitstream component will be to eliminate price discrimination as a feature of the downstream retail market to the detriment of competition and the long-term benefit of end-users of telecommunications services.
8. Professor Hausman (echoed by Mr Goddard) criticises the Commission and says that "the correct regulatory approach is to set the regulated price on the basis of retail minus for each bitstream service Telecom offers". That is also his point that the regulated services should mirror precisely the retail services that Telecom in fact provides. A single average price, he says, will "likely lead to the outcome that only a single (low-speed or high-speed) bitstream service will survive in the market"¹⁰. If the Commission instead adopts a retail minus

⁸ *Ibid*, para. 8.6.

⁹ Hausman evidence, paras. 1-3.

¹⁰ *Ibid.*, para. 16.

strategy for *each* of Telecom's *bitstream* services, he says, the opportunity for regulatory arbitrage diminishes, Telecom will have the correct economic incentives to offer the optimum amount of product variety consistent with the existence of imperfect competition and for investment in new generations of even *higher speed bitstream services*. The Commission's current approach, Hausman concludes, "will incorrectly distort these incentives since Telecom will not be able to recover its investment in higher speed services since the weighted average price calculated by the Commission will [be] below the cost to Telecom of providing those services."¹¹

Questions arising from the Hausman/Goddard view of bitstream pricing

9. Three questions arise from this analysis.
10. The first, and most fundamental, question is whether the economic analysis is based on a confusion of the pricing of the full retail broadband products that Telecom offers (which vary considerably according to the qualities of those end products) and the pricing of a common component of those products which may have no distinguishing feature as between one product and the others. (To use an analogy that is rather different from Mr Goddard's serviced apartment comparison,¹² the manufacturer of Ferraris may well use the same type of bolts as the manufacturer of Volkswagens (without which both cars would fall apart). It is highly doubtful that that fact explains the vast difference in the end price of the two cars. Even if there were small differences in the quality of that component, it is highly unlikely that that would explain, even in small part, the difference in the retail price of the vehicles).
11. The second question is whether requiring the regulated services to mirror Telecom's retail services will work against the establishment of competition in the retail market as contemplated by section 18 by relegating TelstraClear to the role of a reseller of Telecom's services. In my opinion, that is the likely effect of Mr Goddard's view. The Commission's approach, by contrast, will provide TelstraClear with a greater ability to shape its own marketing and product development strategies rather than to have to operate within the confines of Telecom's chosen retail product mix. This will enhance the potential for price and product differentiation in the downstream retail markets and hence achieve the greater competitive intensity that Professor Hausman lauds. Indeed, if a new entrant saw some marketing advantage in segmenting the residential and business customer segments in a different way to Telecom, there is no reason why it should not do so since this will involve competition in the form of price discrimination (and not necessarily its elimination).
12. The third question is whether any difference in the economic approaches taken by the Commission in addressing the first two questions can be said to amount to an error of law that would trigger judicial review or whether the view

¹¹ *Ibid.* para. 20.

¹² *Loc.cit.*, para. 4.12.

¹⁴ *Loc.cit.*, paras. 4.2-4.3.

expressed to date by the Commission (if confirmed) would be within the range of proper decision-making by the Commission and not reviewable accordingly. In my opinion, it is not possible to isolate a question of law from the consideration of this issue. Mr Goddard (and Professor Hausman) are simply expressing a different view on matters of economic policy or, to the extent that issues of statutory interpretation do arise in setting the policy, mixed questions of fact, law and policy.

The Flaw in the Analysis – the confusion of the pricing of the end retail product and the pricing of a component

13. Mr Goddard discusses what he calls “the simplest case”, namely one where the regulated service is identical in all respects to a retail service offered by Telecom. There is, he says, no difficulty in the Commission exercising its duty under the relevant Initial Pricing Principle of making a comparison with comparable services. The retail and wholesale services are the same. It would not, he continues, be appropriate to look to another retail service that has significantly different characteristics and that is supplied at a significantly different retail price merely because the cost to Telecom of providing both retail services was the same.¹⁴
14. So far, so good. However, then (after giving further examples that also involve comparisons with the entire range of retail products) with masterful understatement, Mr Goddard says: “Where the regulated service is a *component* of the service supplied at retail by Telecom, rather than the *entire retail service*, the process of identifying comparable services is obviously a *little more difficult*”¹⁵.
15. Therein lies the problem. Bitstream (as Mr Goddard recognises) is a component and as such it has no actual retail price. The Commission’s task therefore is to impute a notional retail price for it by (as Mr Goddard also recognises) backing out the non-bitstream elements. (From that price there is then deducted a discount that represents Telecom’s avoidable costs. There is apparently no dispute at this point on that matter.)
16. Mr Goddard’s analysis assumes that because the price of Telecom’s retail broadband offerings increases as the speed of the service increases (and according to whether the end user is a residential or business user), the *price* of the component (access) also increases proportionately (notwithstanding that the cost of providing access is the same). This finds expression in the following sentence of his opinion, one that follows immediately after his acknowledgment of a “little” difficulty in moving from comparisons between entire retail offerings and comparisons of components of such offerings:

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.¹⁶

¹⁵ *Loc. cit.*, para. 4.10 (emphasis added).

¹⁶ *Loc. cit.*

17. This exercise however requires a detailed consideration of just what the dimensions are that “drive retail pricing”. Mr Goddard assumes – and certainly does not establish by reference to any technical analysis – that it is the bitstream component that, in whole or substantial part, determines or conditions the speed of the retail product. On my instructions that is not so.
18. Specifically, I am instructed (and I understand that this was the evidence before the Commission) that the network elements which are most relevant to retail speed do not form part of the bitstream service. While the bitstream service can support downstream services to a maximum speed of 7.6Mbps, that is not the same thing as saying that the bitstream service is directly comparable to high speed, end-to-end retail services offered downstream by Telecom. The bitstream service essentially represents the non-speed related elements of the Jetstream service, including the port on the DSLAM open to its full capacity. Downstream retail services of differing speeds are created by setting the port to the required speed (including a setting of no speed constraint) and importantly, provisioning sufficient national and international transmission capacity to support the selected retail speed. This is done by the access seeker in building its retail products – not by Telecom in supplying the bitstream component.
19. Telecom supplies itself bitstream which is unconstrained and then, in devising its retail products, imposes varying constraints and matching network capacity *of its choosing* to suit its marketing strategies (which it is free to change at any time). A new entrant will, quite properly, want the same ability and for that reason will be seeking access to bitstream in the same, unconstrained, form that Telecom supplies itself so that it can thereafter design its own mix of product offerings off that – just as Telecom has done. Giving access seekers this ability is entirely consistent with the Standard Access Principles set out in Schedule 1 of the Act, which sits side by side with the Initial Pricing Principle in the statutory bitstream service description.
20. Mr Goddard acknowledges that, in arriving at an imputed notional retail price for the regulated service, it is necessary to back out elements of Telecom’s price that relate to services other than bitstream. He says however that backing out the “speed premium” is inappropriate “since the same downstream speed is a feature of the regulated service” so that a “substantial component of the imputed retail price after the appropriate adjustments is likely to be the speed premium for an unconstrained speed service”¹⁷. But the so-called speed premium is substantially a feature of the transmission elements that are backed out. It is not referable to bitstream which is not only common across the whole range of Telecom’s retail services but which is largely speed insensitive. Interestingly, it would seem that, by treating the speed premium (which drives the differential in retail pricing) as part of the bitstream component, Mr Goddard is necessarily deducting the transmission components *at cost*, a sin of which he accuses the Commission.

¹⁷ *Loc.cit.*, para. 4.11.2.

21. The point should be made here that, if Telecom responds by asserting that it is the bitstream component which determines the speed characteristics of the end retail product (contrary to the instructions which I have), we will be a light year away from arguing about a point of law but will be into areas of technical dispute about which the Commission will ultimately have to arrive at factual findings. Not the stuff of judicial review.

The Implications for the statutory objective of promoting competition for the long-term benefit of end-users of telecommunications users

22. In my opinion, Mr Goddard's analysis is not only based (on my instructions) on incorrect factual assumptions about the bitstream component, it is also repugnant to the statutory objectives set out in section 18 of the Act.
23. The policy behind unbundling is that it should provide greater opportunities for price and product competition (of which price discrimination is a positive element) than straight resale. The renowned *QCMA*¹⁸ analysis emphasised that competition occurs not just in price but in all dimensions through different forms of price-quality-service offerings. The consequence of unbundling is that competitors will be able to substitute their own network elements for those of Telecom's that are not essential inputs and make their own decisions about retail product dimensions rather than (as discussed above) simply becoming resellers of Telecom's retail products.
24. On Telecom's approach, as reflected in Mr Goddard's opinion, the wholesale pricing, and therefore the competitors' own retail pricing, would continue to be largely constrained by the retail pricing (and speed classification) of Telecom's retail end products. That is neither consistent with the competition objectives of the Act and of the policy that unbundling should provide competitors with incentives to add value and to compete in all aspects of non-essential componentry that will ultimately feed into lower prices and better quality retail products. Nor is it consistent with the efficiency goal in the Act to embed Telecom's retail pricing strategies in wholesale prices.
25. It needs to be remembered at all times that the purpose of requiring Telecom to supply the regulated service – which is specified as a designated service precisely because it does otherwise provide a roadblock to competition developing – is to facilitate competition. Establishing a wholesale price for the designated service (which is essentially the same across all of Telecom's retail Jetstream products) based on Telecom's pricing strategies, no matter how sound those strategies may appear, is inconsistent with the statutory purpose of promoting competition. This would be even less consistent with the Act's objectives where those retail pricing strategies have developed in markets in which the Commission has found Telecom faces limited competition.
26. Finally, in relation to Mr Goddard's complaint that the Commission should undertake an efficiency analysis which compares the proposed single

¹⁸ *Re Queensland Co-operative Milling Association* (1976) 8 ALR 481, 515.

regulated service with *each* of Telecom's product offerings, it should be pointed out that:

- a. The Commission (in its investigation into Unbundling the Local Loop Network and the Fixed Public Data Network¹⁹) has already conducted a cost benefit analysis ("CBA") of the advantages of regulating bitstream, an analysis that must have been predicated on the greater degree of price and product competition achievable by a bitstream service compared to resale. The Commission, it should be noted, found that the regulation of bitstream gave rise to positive benefits to the consumer – hence the designation that followed. An unconstrained service allows realisation of the very type of efficiency gains the Commission modelled in its CBA whereas, for the reasons outlined above, Telecom's approach amounts, in practice, to another form of resale.
- b. The timeframes provided by the Act for the determination of the price and terms of a designated service, on the application of an access seeker, are very limited – 50 days²⁰ - and it is clear that the Act contemplates that the process of investigation may necessarily be a more truncated one than it would be on a pricing review under section 42 where there is a fuller statutory process provided and no specific time limits on the bringing down of the Commission's determination. It could not have been contemplated that the Commission would have been required, as a matter of law, to use such a complex and involved tool as a CBA to determine key supply terms.
- c. The Commission plainly has considered efficiency issues throughout the bitstream proceedings. The extensive debate on price discrimination, including expert economic evidence from both parties, is but one example. In my view, the Commission's approach to the efficiency issues, given the nature of these proceedings has been more than adequate.

Conclusion

27. For the reasons set out above, my opinion is that Mr Goddard's opinion is based on factual assumptions that, on my instructions, are incorrect. For that reason alone, his economic and legal analysis is flawed. Far from undermining the statutory objectives, the approach indicated by the Commission will enhance them.
28. I am also of the view that Mr Goddard's analysis, whether correct or not, does not isolate questions of law that would be amenable to judicial review.

¹⁹ Final Report, December 2003.

²⁰ Section 28(1)(b).

29. I have not in this opinion dealt with Mr Goddard's views on the procedural questions of case stated and judicial review. They are now the subject of judicial review proceedings issued by Telecom and will be tested on the strike out applications filed by TelstraClear and the Commission. However, I am very firmly of the opinion that the scheme of the Act is plain and that attempts by Telecom to interfere with the natural course of the Commission's investigation and determination are misconceived.

Yours faithfully,

A handwritten signature in black ink, appearing to be 'J A Farmer', with a long horizontal flourish extending to the right.

J A Farmer QC