



Telecom New Zealand Limited

Comments in respect of the

**Application by CallPlus Limited for
reconsideration of Decision 582**

20 December 2006

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A INTRODUCTION

1. CallPlus Limited ("**CallPlus**") has applied for a Reconsideration of Decision 582 pursuant to section 59(1) of the Telecommunications Act 2001 ("**Act**"). By letter dated 14 December, the Commission has sought comments from Telecom on "any matter that Telecom considers relevant to the Application".
2. This Application follows an earlier application by iHug Limited for Reconsideration of Decision 582. The Commission has not yet advised whether it proposes to deal with the two applications together, but Telecom considers that would be appropriate. For this reason, Telecom does not propose to repeat the comments it made in the submissions on the iHug application dated 15 December 2006. Comments in the introduction regarding process and the whole of section B (the legal framework) are equally applicable to this application. Equally, comments in this submission regarding the appropriate approach to calculate the bitstream access price are applicable to the iHug application. Telecom requests that this submission and its submission of 15 December 2006 be read together in response to both the iHug and the CallPlus applications for a Reconsideration of Decision 582.
3. CallPlus seeks a reduction of the bitstream access price and amendment of the price adjustment mechanism together with related amendments. It does not seek a change to the 16% discount.
4. CallPlus' letter of application sets out 13 "reasons" for the application. Most of these are not valid reasons or grounds for reconsideration in terms of section 59 of the Act. In essence it appears to be CallPlus' submission that where a party takes the view that a Determination does not meet or no longer meets the stated purpose of Part 2 of the Act, as set out in section 18, and the Commission agrees, then one or more of the grounds for reconsideration in section 59 become available to the Commission to amend that Determination. For the reasons set out in more detail below we disagree.
5. Telecom has agreed to participate in this Reconsideration on the basis that it is in the interests of the entire industry to have certainty and transparency in relation to the pricing of the bitstream service. Telecom has always had concerns about the Commission's pricing methodology for the bitstream access service and it welcomes the opportunity to participate in a Reconsideration of that pricing methodology.
6. Consistently with the submissions made prior to Decisions 568 and 582 Telecom considers there is an alternative pricing methodology that better responds to changes in Telecom's retail product line up and better meets the requirements of the Act. In section B of this submission, Telecom describes the methodology that it considers best meets the requirements for retail minus pricing required by the initial pricing principle in the Act. Telecom's

proposed methodology takes into account the continually evolving retail market to ensure that the bitstream access price continues to closely reflect the retail services supplied by Telecom. This methodology proposes using a weighted average model, reflecting the services provided at the time the price is reviewed.

7. Due to time constraints, the following section merely describes the methodology, without providing a detailed calculation of the bitstream access price that would be derived using this methodology. In addition, if Telecom were to provide a detailed calculation, it would be necessary for Telecom's confidential information to be protected. The Commission has indicated that it will make a confidentiality order under section 100 of the Commerce Act, but the Commission has not yet made its order.
8. These submissions deal with:
 - 8.1. Telecom's alternative methodology for calculating the bitstream access price (section B)
 - 8.2. Comments on CallPlus' application (section C).

B TELECOM'S ALTERNATIVE METHODOLOGY FOR CALCULATING THE BITSTREAM ACCESS PRICE

9. Telecom refers to its 12 April 2006 submission in the Decision 582 proceedings and in particular paragraph 112 where it set out the basis of a WARP methodology. Telecom remains of the view that that methodology addresses the concerns which the Commission and the applicants have subsequently raised.
10. The method submitted here is essentially the same, although it now works better because there is no longer any need to adjust for differences between 3584/128 services and a regulated unconstrained/128 service. Also, there are now more plans which are comparable to the regulated service, making the averaging process more robust. Telecom considers that all of its retail unconstrained/128 plans are comparable services, but that its unconstrained upstream services (such as the Pro plans) are not.
11. The order of the calculation set out in paragraph 112 of the 12 April submission could still be used, but the order outlined here is a more natural one which produces the same result.
12. We will refer to the methodology as the Alternative WARP methodology, to avoid any confusion with the updating methodology determined by the Commission in Decision 582.

Steps in Alternative WARP Methodology

13. **Step One – identify the appropriate retail plans to use as a starting point.** The weighted average should be calculated over all of Telecom's unconstrained/128 retail plans. Plans with and without calling discounts should be included. The "with calling" plans need an imputation adjustment for the tolls discount as described below. The plan counts, and therefore the weightings should be based on connection counts rather than subscriber or customer numbers as there are definitional difficulties in relation to anything other than "connection". Further, Telecom's retail approach is based at the individual connection level rather than by customer. This is evidenced by the absence of bulk-purchase discounts when a single customer buys a large number of broadband connections.
14. **Step Two – impute out the tolls discount.** Plans which provide for a discount when the customer has calling with Telecom in relation to the connection over which the broadband is provided ("with calling plans") need to have an imputation adjustment to allow for this. This adjustment should be the standard bundles imputation adjustment set out in the Act (Retail services

offered by means of Telecom's fixed telecommunications network as part of a bundle of retail services) as the Commission set out in its original IPP consultation document of 18 January 2005. This requires that the discount be spread across the components of the bundle in proportion to the stand-alone prices of the services within that bundle.

15. In Decision 568 at paragraph 379 the Commission determined that there should be a departure from the standard bundles imputation approach in that the stand-alone price of Homeline should not be accounted for in the calculation. This was on the basis that "it is unlikely an equally efficient access seeker would be able to profitably provide the Homeline service as a stand-alone service." We considered this reasoning to be incorrect at the time as the bundle imputation methodology outlined in the Act does not provide for the exclusion of services that would be unprofitable if provided as stand-alone services. Further the reasoning has less validity now in that stand-alone provision is viable:

15.1. The discount provided in relation to Homeline as a resale product is now 5% rather than the 2% provided at the time of Decision 568.

15.2. Mark Rushworth of iHug has publicly confirmed that stand-alone provision of Homeline is viable, albeit only just. Mr Rushworth has stated that "For home phone it's a break-even product but regarding toll calling or the calling packages, there's enough margin in there to manage the business."¹

16. For these reasons the standard bundle imputation methodology in the Act should be employed, rather than the non-standard one used in Decision 568.

17. The imputation should be done across the Homeline price and the estimate of average residential toll call spend which was used in previous Decisions. This spend estimate now needs to be updated given the price reductions in the tolls market since that value was calculated. Applying the (new) residential spend estimate across business connections also would understate the result slightly. There should be a separate calculation to allow for the higher average rental and toll spend of business customers. The recalculation of tolls spend should measure across both business and residential customers of broadband services.

18. **Step Three – adjust for overage revenue.** The next step, which was not previously required because of the plans being used, is to adjust for the

¹ Morning Report 28 September 2006

overage revenue on any plan which does not have "throttle on cap". Currently this relates only to the Basic plan. CallPlus marketing manager Mark Callander highlighted the importance of this issue in *Telecommunications Review* when he stated "The majority of customers who are attracted to these low broadband price points [such as the Basic plan] will end up paying hundreds and in some cases thousands in overage charges."² The claim of hundreds of extra dollars from each customer is hyperbole, but nevertheless overage revenues are an important part of the economics of being able to provide such plans at low per-month prices.

19. A "Callander adjustment" therefore needs to be made to the monthly price of the Basic plans where the average overage revenue is added to the monthly price at this stage of the calculation. The price included in the WARP calculation should reflect the actual revenues Telecom is obtaining from the product, as the price is more than just the monthly rental. This adjustment would have the effect of materially increasing the Basic price, but with much less effect on overall resulting UBS price because of the relatively small number of customers on the Basic plan, when compared with other Telecom retail plans.

20. Step Four – subtract the broadband specific costs of running an ISP.

Next the costs of running an ISP need to be subtracted as part of the imputation of the underlying retail price as these costs are avoided when broadband is provided as UBS rather than as retail Xtra Broadband. Telecom has previously provided details of the cost of these activities to the Commission.³ The cost is confidential and Telecom is happy to provide it as restricted information once the Commission has made its section 100 Order in respect of the Reconsideration applications. The value needs to be grossed up by 16% as it is a cost which will have 16% subtracted again at a later stage of the calculation.

21. Step Five – deduct the costs of backhaul. Next a deduction should be made for the costs of backhaul. The access seekers' seek a deduction for backhaul of \$1.92 (grossed up by 16%), although that number will need to be updated through this submission process as it does not reflect changes made recently to the way Telecom provides commercial backhaul to its wholesale customers. Telecom has not yet worked out the appropriate number to be deducted for backhaul, although we anticipate that it will be less than \$1.92. We will provide further information about the changes and the appropriate deduction during the submission process.

² Telecommunications Review 4 December - 28 January, page 8

³ Telecom's submission dated 20 May 2005 on the Commission's draft determination in the TelstraClear bitstream access application, annex F, paragraph 5.

22. The explicit subtraction of ISP costs and backhaul costs represents an alternative to the Commission's previous approach of simply subtracting an arbitrary \$8.89 per connection from the price to allow for these two factors. The \$8.89 has no current referent in Telecom's retail prices as it related to an historical difference between two products which Telecom no longer sells. While the resulting value is similar with either method, the Telecom method is more explicit and accurate. The deduction of backhaul was an issue in CallPlus and iHug's appeal of Decision 582, because although a deduction for backhaul had been made it was unclear whether the deduction was part of the \$8.89, or part of the "transmission" deducted by the Commission.
23. Note that it would not be correct to subtract \$8.89 as an allowance for the overall costs ISPs incur and then to subtract off another \$1.92 for backhaul as backhaul is one of the costs incurred by ISPs in relation to that historical difference between the two types of plan (with and without ISP). Subtracting twice would represent a double-count of this cost. Explicit deductions of identified costs is the most transparent way to impute underlying retail prices.
24. **Step Six – deduct the costs of national and international bandwidth.** The next deduction is for the costs of national and international bandwidth. Telecom now submits that this is better done on a plan-by-plan basis before calculating the weighted average as it provides for the situation where the cost per Gigabyte differs between plans. Previously with only Explorer and Adventure this was not an issue. The price per Gigabyte is calculated for prevailing rates for national and international backhaul (priced in \$/Mbit/s) and a calculation of the number of Gigabytes per month which are transmitted for each Mbit/s. The resulting price per Gigabyte is multiplied by the number of Gigabytes for each plan which are actually used rather than the allocated number before throttling or overage applies. By using Gigabytes used, as opposed to Gigabytes permitted under the relevant plan, the Commission can avoid any issue that arises with Telecom's Go Large plan, which has no data cap. Also the method becomes more responsive to changes in customer behaviour as the usage is re-measured each quarter. This step imputes out the price paid by an ISP for the data it supplies to its end users and is analogous to the backhaul deduction which imputes out the prices paid by an ISP for backhaul.
25. **Step Seven – "Go Large" adjustment.** A further adjustment will be required in relation to Telecom's Go Large plans as these have different costs of traffic per Gigabyte. The traffic on these plans is managed, particularly during peak periods, specifically so that it will impose lower costs per Gigabyte on Telecom's network and backhaul capacity. Users on these plans have their traffic separated from other users' traffic and are allocated a certain number of kbit/s per connection. This allocation is Telecom restricted information, which we can provide once the Commission makes a section 100 Order. This means the traffic cost calculation for these plans uses the \$/Mbit/s prevailing market

rate and spreads this across the number of users per Mbit/s given each user's allocated speed.

26. **Step Eight – calculate the weighted average of all plans to derive the imputed retail price.** The figures to this point will have all been calculated on a plan-by-plan basis. The next step will be to calculate the weighted average across all plans to define the imputed retail price. The benchmarked discount of 16% then needs to be subtracted from this resulting value.
27. **Step Nine – make an adjustment for the different VP consumption of different ISPs.** As noted in the 12 April submission, there should be an adjustment made to allow for the fact that some ISPs place a greater load on shared VP capacity than other ISPs. Each shared VP attached to a DSLAM is dimensioned on a collective basis across all broadband providers providing services off that DSLAM – Xtra Broadband, WBS, and UBS. However if one ISP has an unusually high proportion of high usage customers that ISP will be utilising more than its proportionate share of the capacity of that VP. A flat UBS price cannot take account of this and represents a cross-subsidy from low use ISPs to high use ones which would result in an inefficient economic outcome and therefore would not meet the requirements of s18(2) of the Act.
28. One solution to this would be to calculate a separate UBS price for each ISP which is what Telecom had previously advocated. However this requires ongoing measurement of each ISP's usage and the bespoke pricing is operationally more difficult to implement. Telecom now considers that a better approach is to impute out the effect of VP consumption as a separate charge and have this charged separately from and additional to the UBS charge. The usage each ISP makes of the network can be reasonably measured by the handover link capacity per end user it specifies. This number is selected by the ISP according to what overall speed it wants to provide to its user base. It can be changed by the ISP, but it is unlikely to be changed that often, reducing any re-calculation issues.
29. For its retail services Telecom recovers the costs of VP consumption through its data charges varying by plan. High use customers need to select a higher Gigabyte plan and correspondingly pay more. This means that if all retail data charges are subtracted in the calculation of the UBS price (as happens with the Commission's previous Data=0 regression method) the savings from Telecom desisting from retail supply will have been overstated – some data-related costs actually remain. Conversely, subtracting only the backhaul-related data costs would understate the savings by implicitly assuming that lower utilisation of UBS connections resulted in no savings in the shared VP.
30. More analysis of this is required than possible in the time available for this submission, but Telecom currently estimates that around \$2 extra should be subtracted in relation to a 16 kbit/s handover link ISP. This is the value for

Xtra which defines the imputed UBS price. The add-back by ISP would then be between \$2 and \$4 depending on that ISP's handover Permanent Virtual Circuit (PVC) capacity, depending on that ISP's usage of its handover link.

31. **Step Ten – adjust on a quarterly basis, or whenever a Telecom broadband plan price change occurs.**⁴ In order to update the bitstream access price, the alternative WARP methodology would see a recalculation of the number using the methodology outlined above. This is the best methodology for ensuring that the bitstream access price continues to be linked to the retail broadband plans in the market at the time of the adjustment. The result is that there is no risk that the bitstream access price becomes divorced from the plans in the market, thus the price is future proof.
32. Telecom considers that this updated alternative WARP methodology will meet all of the concerns the Commission might have in relation to the pricing and price adjustment methodology from Decision 582. Some specific points to note are:
- 32.1. The imputed retail price will be weighted by reference to measured connection numbers on each of Telecom's comparable retail plans.
- 32.2. The methodology will make adjustments for changes in non-price terms. For example the Callander adjustment and the special treatment of Go Large due to its different provisioning criteria.
- 32.3. Any changes in data caps by plan will be allowed for to the extent they change customer behaviour (customers actually using more as a result of caps being lifted) and hence competitor costs. As an example of the effect of Telecom increasing the number of Gigabytes on one of its retail plans, the way this flows through Telecom's pricing methodology can be tracked. In Step Six (the bandwidth adjustment) the price per Gigabyte would be multiplied by an increased number of Gigabytes on the plan or plans where the change has occurred. This means that there would be a larger deduction for the costs of national and international bandwidth and the resulting UBS price drops accordingly.
33. In Decision 582 at paragraph 187 the Commission rejected the weighted pricing mechanism submitted by Telecom at that time on the ground that it was not consistent with a retail-minus pricing regime. We believe that the alternative WARP methodology follows exactly the requirements for a retail-minus pricing approach. It looks at retail prices and removes the costs which

⁴ In line with paragraph 208 of Decision 582.

are avoided when a service is being sold as UBS rather than Xtra Broadband. The fact that it does some of this avoided cost removal as part of the retail price imputation and some as part of benchmarked retail costs is not relevant. The Commission's determined method makes similar subtractions and for similar reasons, yet the Commission considered that its own method did represent retail-minus. Telecom's method is robust and objectively measurable and provides an allowance for all the costs an ISP would incur in competing with Telecom's corresponding retail products.

C COMMENTS ON CALLPLUS' APPLICATION

34. We now make detailed comments on the 13 numbered "reasons" for CallPlus' application listed starting at the bottom of page 1 of the letter of application.

"Failure to correctly set price / failure to fulfil sections 18 & 19" (paras 1 – 5 and 7)

35. Paragraphs 1 – 5 and 7 allege in various places that Decision 582 did not "correctly set" the initial price or the price review mechanism and / or did not set them in such a way as to fulfil the requirements of section 18 and 19 of the Act. Telecom disagrees. However even if these allegations were true they would not afford a proper basis to reconsider the Determination under section 59. The Commission clearly took the view at the time it issued the Determination that the price was correctly set and that the requirements of sections 18 and 19 were fulfilled. Even if the Commission now takes a different view this would not enliven one of the permitted grounds for reconsideration under section 59.

36. This Reconsideration is not an opportunity for the Commission to "fix up" the bitstream access price if it considers that the methodology previously adopted was not correct. As outlined in our submissions in response to iHug's application for a Reconsideration, the Commission's jurisdiction on an application for a Reconsideration is a limited one. The Determination can only be reconsidered if one of the grounds in section 59(1) exists and any adjustment must be linked to the relevant ground.

"Material change of circumstances" (paras 6, 7, 12)

37. CallPlus says (at paragraph 6, with reference to paragraph 5) that observations of retail prices, actual and potential costs, "market developments generally", and "any other information the Commission has or will receive" since the date of the determination, including the Commission becoming aware of these matters "constitute material changes of circumstances."

38. This allegation is hopelessly vague. Telecom cannot reasonably be expected to respond to this without at least some kind of indication as to what "market developments generally" are being referred to.

39. At paragraph 7 CallPlus says that the Telecom ADSL-based retail broadband plans and migration of Telecom's customers across its plans particularly during October 2006 constitute a material change of circumstance. CallPlus does not say why this amounts to a material change of circumstance. Details of the Telecom October 2006 plans together with other service providers' plans appear in the Appendix attached to our submissions on iHug's application for a Reconsideration. Telecom's view is that developments in the broadband

market of the type which occurred in October 2006 were contemplated in Decision 582. CallPlus simply asserts they constituted a material change of circumstances without explaining why that is so. Without more, it is not possible to respond to this assertion at this stage.

40. At paragraph 12 CallPlus asserts there have been material changes to products, services, price and non-price terms, and material changes to the market. None of these is identified. Telecom cannot reasonably be expected to respond to these assertions without more detail.
41. The application refers to price review reports to the Commission by John de Ridder and Michael Wigley and "material submitted by the access seekers to the Commission in relation to price squeeze allegations". The Commission is not required to consider price squeeze allegations in the context of applying the initial pricing principle for bitstream access services. Accordingly, these documents are not relevant to this Reconsideration. However, should the Commission take the view that these documents are relevant, natural justice would dictate that copies of the documents be provided to Telecom.

"Incomplete and therefore false or misleading information" (paras 6 and 8)

42. As noted above, simply because time has passed and therefore more information is (or will be) available to the Commission now than was available at the time of the Determination, it does not follow that the information that was available to the Commission at the time of the Determination was false or misleading. What section 59(1)(c) requires is the identification of some aspect in which the material provided to the Commission at the time of the Determination was false or misleading in a material particular. CallPlus does not even attempt to identify this information.
43. At paragraph 8 CallPlus says that "If the changes to retail plans and customer migration, effected in October 2006, were known (to a greater or lesser degree) prior to the determination, but not communicated to the Commission, then the lack of complete information constitutes misleading or false information." CallPlus does not allege that the changes were known. Telecom denies that they were. Further, even if they were, Telecom denies this would render the other information provided to the Commission false or misleading. CallPlus has not even attempted to explain the reasoning or logic behind its submission here. On its face there is none.

Clarification to deal with non-price terms (paras 9 and 13)

44. CallPlus requests clarification of the Determination to deal with non-price terms such as movement of data caps and migration of customers. There is some overlap / repetition in this respect between paragraphs 9 and 13.

CallPlus asserts that this clarification is “necessary” but does not explain why this is so.

45. Telecom’s response is that this is not a request for clarification in terms of section 59(1)(b). It is simply a request for amendment. The scope of the Commission’s power to clarify is discussed in section B of our submissions in response to iHug’s application. Clearly no issue falling under section 59(1)(b) arises in this instance.
46. The methodology proposed by Telecom in the previous section will address any concerns that CallPlus might have in this area.

The initial price, and the price changes following price reviews are not such as to allow an equally efficient access seeker to compete (para 2)

47. Similar allegations are made in the recent iHug application and we refer the Commission to Telecom’s comments at paragraphs 25-29 of our submission in response to that application.

Scope of powers to amend under section 59 (para 10)

48. Although it is not strictly speaking a reason or ground for reconsideration, CallPlus also refers in its “reasons” to the scope of the Commission’s powers to amend a determination under section 59. For the reasons already set out in Section B of our submissions in response to iHug’s application Telecom disagrees that the Commission’s power is as wide as CallPlus suggests. Reference is made to the Commission’s own previous comments in Decision 489.