



**Telecom New Zealand Limited**

**Cross Submission in respect of the**

**Commerce Commission's Draft Reconsideration of  
Decision 582**

**Public Version**

**21 March 2007**

**CONTENTS**

A. Introduction	3
B. Pricing Methodology	4
C. Additional Requirements	8

## **A INTRODUCTION**

1. The submissions of all the parties on the Draft Reconsideration all appear to agree that the Commission's new pricing methodology for calculating the UBS price is preferable to the methodology adopted in Decisions 568 and 582. The arguments are about certain key inputs, rather than the methodology as a whole.
2. In terms of the pricing methodology, there are two key issues, namely how to allow for ISP Backhaul and Data Transmission. We deal with these issues in section B.
3. The submissions show that there is considerable confusion and uncertainty around the Commission's proposed adjustment mechanism for the UBS price. Telecom maintains its view that there is too much uncertainty to include this kind of requirement in the final Reconsideration Determination. The Commission's concerns should be adequately met by the robustness of the methodology in the Draft Reconsideration and by the fact that if there is a material change in circumstances (which could include an alleged price squeeze situation), the parties can apply to the Commission for a further Reconsideration. In addition, Telecom is prepared to consider committing to seeking to implement a strategy similar to Telstra's PEF strategy as part of the operational separation undertakings. We deal with this issue in section C.
4. CallPlus has, once again, submitted that it requires access to Telecom's confidential customer connection information.<sup>1</sup> We do not agree. As we said in our letter of 26 February 2007, we do not consider that it is necessary for confidential customer connection information to be provided to the access seekers in order for them to comment on the Draft Reconsideration. The data already provided, together with the spreadsheets offered by Telecom with our submissions, will enable the access seekers to test and, if necessary, to challenge the Commission's methodology. They have no ability to challenge the actual data, as the information is Telecom's own connection information. We would therefore resist very strongly any suggestion that this data be designated as anything other than Commission Only information under the Commission's confidentiality regime.

---

<sup>1</sup> CallPlus submission, paragraph 2.5.

## **B PRICING METHODOLOGY**

### **Introduction**

5. There is a significant difference between the submissions of Vodafone/iHug and Orcon on one hand and CallPlus on the other. The first two generally agree with Telecom and the Commission except in regard to the treatment of backhaul costs. Mr de Ridder's report proposes a confusing alternative to the approach the Commission and the rest of the industry seem to have agreed on in relation to adjusting for data costs. Telecom's cross-submission focuses on the backhaul issue as that is where there appears to be the greatest degree of confusion with every party, including the Commission, taking a different approach.

### **Definitions**

6. Part of the reason for the confusion may be to do with the different definitions which are used in relation to the various costs involved in providing the final retail broadband service to end users. In particular "backhaul" and "data transmission" are sometimes used to mean the same and sometimes different things. This is understandable as backhaul involves the transmission of data and data transmission includes the use of backhaul.
7. The CallPlus submission at its paragraph 3.5 usefully sets out the components of a retail broadband service. Telecom agrees that conceptually these five elements exist, but disagrees with CallPlus as to the specific boundaries between those components.
8. These components (in no particular order) are:
  - (a) UBS. This is the underlying service supplied to ISPs and corresponds to the physical part of the Telecom retail broadband service between the end user and the first ATM switch.
  - (b) ISP Service. Telecom views this as the non-retail costs of running an ISP, but excluding the variable costs of "Data transmission". We consider that this includes the costs the ISP has of transporting data within its network whether on a self-provided basis as Xtra and TelstraClear do, or on a rented basis as most other ISPs do. These costs are in addition to other core ISP services such as owning servers and providing email.
  - (c) Data Transmission. Telecom views this as the service discussed at paragraphs 92 to 97 of the draft reconsideration. It involves the national and international costs of moving data across the internet

beyond the trunk side (wider network end) of the ISP. The bulk of the cost here is in relation to the provision of international bandwidth.

- (d) Retailing costs. These are the costs such as sales, marketing, billing, and non-technical customer support<sup>2</sup> which a reseller of ISP service would incur. These are covered by the 16% discount.
- (e) Backhaul. This should be distinguished from Data transmission as it is the activity of moving data from the handover point at the first ATM switch to the line side (end user end) of the ISP's own switching functions. As noted above, Telecom considers this to be a part of ISP service, but if the two need to be distinguished, they could be named "Core ISP service" and "ISP Backhaul".

### **Allowing for ISP Backhaul**

- 9.** The access seekers maintain that an adjustment should be made for the costs associated with ISP Backhaul and estimate \$1.92 per end user per month as the quantum. The Commission has said at paragraph 88 that Telecom's argument about double-counting relates to national and international data transmission.
- 10.** To be clear, Telecom's concern in relation to double counting is in relation to ISP Backhaul, not Data Transmission. The access seekers maintain that the retail value of ISP Service (the Commission's \$8.89 figure which was the difference between residential retail prices including and excluding the ISP charge) should be subtracted and that the wholesale charges for ISP Backhaul (estimated at \$1.92) should be subtracted as well. However the \$8.89 is an historical figure which covered the costs associated with both the Core ISP service and ISP Backhaul service provided by ISPs at the time that figure was set. One of those services was the backhaul connections to the ISP which were either self-provided by the ISP or were sold by Telecom as the Fast IP or Fast IP Direct products. The Fast IP products (relating to ISP Backhaul) were distinguished from Data Transmission as that was still paid for by the end user directly to Telecom.
- 11.** All of the parties agree that there should be a subtraction for Data Transmission although there is still disagreement around how that should

---

<sup>2</sup> Technical customer support is an ISP Service function.

happen. This is dealt with further below. The debate is around Core ISP Service and ISP Backhaul.

12. Telecom's position is that there should be a cost subtraction for Core ISP Service and a cost subtraction for ISP Backhaul. The Commission's position is that there should be a retail-related subtraction of \$8.89 for the sum of these services, ISP Service. The access seekers however suggest that the ISP Backhaul allowance (which is part of the \$8.89) should be subtracted again which is clearly not correct. The de Ridder report does not disagree with Telecom that backhaul should be ignored to avoid double-counting, although it does note that ISP service costs are uncertain.

### **Data Transmission**

13. Only the de Ridder report takes significant issue with the Telecom and Commission approach of applying prevailing market prices to actual usage measures to adjust out the price of Data Transmission. There appears to be a concern that subtracting off the cost of usage at prevailing (wholesale) market rates would only subtract off cost rather than "value" and that that would produce an inappropriate result. This of course is inconsistent with the recommended approach of removing backhaul at prevailing wholesale rates.
14. The recommended approach to Data Transmission appears to be that all data cap-related price discrimination present in Telecom's retail charges should be backed out using the regression methodology already rejected by the Commission (Options C and D). However Telecom is required economically to undertake such discrimination in order to be able to provide cheaper entry level plans. All other ISPs do a similar thing under the current UBS structure. If the entire value of this was removed it would give ISPs a free ride on the subsidised entry level plan. Telecom would have little choice but to remove the discrimination at retail with the corresponding flow-through to UBS and the serious adverse consequences for New Zealand's broadband penetration. An example of this has already been seen with the removal of speed-related price discrimination.
15. The suggestion is also made that "budgeted" data usage should be measured rather than actual usage. It is not entirely clear what this refers to, but it does appear to be distinguished from "data cap" as de Ridder states that "data cap seems a reasonable proxy for budgeted usage." Telecom notes that budgeted usage is a better proxy for actual usage than for data cap as when one sets a budget one tries to estimate as closely as possible what the actual value will be. There will however always be variations between the budget and the actual.

- 16.** It is suggested that budgeted usage will be more stable than measured actual usage and that risks for access seekers would be reduced by using it. While it is true that actual usage varies, it does not do so significantly from quarter to quarter, particularly having regard to the large base of existing customers. It is re-measured every quarter and appropriate adjustments are made as a result of any changes. ISPs therefore have no more risk than Telecom in relation to any changes within a quarter as fluctuations are as likely to go one way as the other. The other difficulty is in relation to how the budget is set. There is the purely theoretical possibility of Telecom deliberately setting a low budget value to game the process by reducing the measured data usage and thereby increasing the UBS price. Telecom's recommended approach of regularly measuring actual values eliminates this possibility.
- 17.** A comment is made that the Commission's placeholder figure of \$1.50 per Gbyte would be at the lowest end of the spectrum. This comment however is inconsistent with CallPlus' own pricing policy. Slingshot offers for example a "Data Block" on its broadband plans of 50 Gbytes priced at \$40 per month incl GST. This is 71.1 cents per Gbyte excl GST. While Slingshot would be expecting that customers on average would not use the whole block, they are likely to use well over half of it as otherwise they would have purchased a 30 Gbyte block which is a cheaper option also offered. It is difficult to see how Slingshot could be selling Data Blocks at \$0.711 per Gbyte if it had a Data Transmission input cost in excess of \$1.50 along with the other costs it would be incurring in providing this product.

## C ADDITIONAL REQUIREMENTS

18. There is a real question as to whether the Commission has jurisdiction to impose any ad hoc process of the kind proposed at paragraphs 121 and 125. As we understand it, the Commission's fundamental concern is to avoid wholesale customers being subject to a price squeeze. To justify the process proposed, the Commission identifies in its draft determination the prospect of Telecom "gaming" the regime with a result that is adverse to access seekers. In fact, Telecom would say that the margin between retail and wholesale is more likely to be disrupted by legitimate, end-user focussed retail level innovation to which the current UBS methodology is not sufficiently sensitive. But the point is that, whatever conduct triggers this situation, section 59 was included in the Act for precisely this purpose. If the UBS price no longer appropriately tracks retail activity, the "material change of circumstances" will give rise to a right to have the UBS pricing methodology updated via a Reconsideration. There is no scope for the Commission to supplant this statutory process with a completely novel device as uncertain and open-ended as that proposed in the draft determination.
19. Unsurprisingly then, there is a considerable amount of confusion between the parties as to precisely what the Commission is proposing in paragraphs 121 and 125 of the Draft Reconsideration. Both Telecom and Vodafone have submitted that it is unclear how the adjustment process will work. Mr de Ridder suggests that the nature of the analysis Telecom should apply is clear, namely the mirror image of the process for setting the UBS price. CallPlus' submission suggests that the approach in paragraph 123 of the Draft Reconsideration should go further and that there should be a requirement that if (i) the margin between the planned retail prices and the regulated bitstream price is insufficient to cover Telecom's avoided costs saved, or (ii) that a reasonably efficient access seeker could not compete, using the regulated service determined by Decision 582 and the Reconsideration, then the price of the regulated bitstream service must be adjusted.
20. CallPlus seems to be suggesting that Telecom, having worked with the Commission and the industry for over 2 years to develop a robust UBS pricing methodology, should also be required to meet an entirely separate, parallel pricing standard having no foundation in the Telecommunications Act. That cannot be right. Even if, contrary to Telecom's submission above, the Commission can insist that some kind of additional process take place to update the UBS price more frequently, that process can only draw on the methodology already appropriately determined under the Act. In our considered view the Commission does not have jurisdiction to impose a competition law style "price squeeze test" on Telecom prior to any price adjustment. To do so conflates the

requirements of competition law, with the Commission's jurisdiction under the Telecommunications Act 2001.

- 21.** A poorly specified test – or one that is rigidly applied without appropriate regard being had to the wider competitive context - may unnecessarily limit the ability of Telecom's retail business to compete. This would reduce price pressure and innovation and have a significant impact on service availability to retail customers. This would be contrary to section 18 of the Act.
- 22.** There is no real clarity in the Draft as to what the Commission's proposed analysis would involve, or how it would be applied. The range of choices available may, in part, explain the confusion and divergence of views set out in the submissions. Take for example the test advanced by John de Ridder. That test is limited by the UBS service defined in the Determination. This means that the test can only reflect retail products chosen to derive the Determined price i.e. those chosen for regulatory expediency. As outlined in our previous submissions, operators already compete on the basis of a significantly wider range of services than the products that the UBS price is based on. Yet while that test would be manifestly inadequate, there is no jurisdiction for the Commission to design anything that more faithfully tracks the actual market dynamics.
- 23.** If the adjustment mechanism proposed by the Commission in the Draft Reconsideration were ultimately deployed, obtaining agreement to changes to price or product will inevitably take a significant amount of time and be contentious. There will be strong incentives for service providers to game the process. Accordingly, the proposed adjustment requirements have the potential to materially delay Telecom's ability to respond to competition or bring new services to market. This would be contrary to section 18.
- 24.** The overall effect of the Commission's proposal is that Telecom's Retail business will be seriously constrained in the market. This will have a significant impact for our retail business and customers.
- 25.** Although Telecom's strongly held view is that the adjustment mechanism proposed by the Commission is not contemplated in the Telecommunications Act and would be unworkable in practice, we do recognise that the Commission appears to have a concern about the risk of wholesale customers being subject to a price squeeze. We consider that such concern would best be addressed in the context of operational separation and, more particularly, accounting separation. It is hard to envisage how a price squeeze test could be properly formulated without being informed about the form and substance of separation given the profound effect this will have on where revenues, costs, assets and

incentives are likely to lie. The appropriate place to include any requirement for a price squeeze test is in the context of pricing equivalence. We consider that the approach taken by the ACCC and Telstra with Telstra's Pricing Equivalence Framework (PEF) strategy<sup>3</sup> is the right approach to deal with such issues.

- 26.** The purpose of the PEF strategy is to provide Telstra's competitors and the public with assurance that Telstra is acting "legitimately" in the pricing of its services. This appears to be precisely the concern that the Commission is trying to address with the proposed adjustment mechanism.
  
- 27.** Telecom is prepared to consider committing to seeking to implement a strategy similar to Telstra's PEF strategy as part of the operational separation undertakings.

---

<sup>3</sup> Available at [http://telstrawholesale.com/custsupp/performance\\_separation.cfm](http://telstrawholesale.com/custsupp/performance_separation.cfm), last accessed on 27 February 2007.