

Tuesday, 13 March 2007

Neville Lord
Chief Advisor
Network Branch
Commerce Commission
WELLINGTON

Dear Neville,

lhug and Vodafone submission on draft reconsideration report

1. This is Vodafone and lhug's submission on the Commission's draft reconsideration of decision 582.
2. We have just a few comments to make. As you know, we also commissioned jointly with CallPlus a report from John de Ridder.
3. Generally we very much prefer the Commission's new method for calculating wholesale prices from Telecom's retail prices. The new method is better able to guard against price squeezes. We are also pleased that the Commission will no longer use the WARP method to adjust UBS prices for changes in retail prices, nor regression analysis to remove the costs of data from the retail price.
4. We do have some concerns about the new method. There are some choices that the Commission needs to make, particularly about how to estimate the "minus" to be applied in respect of backhaul and data costs.

Backhaul costs should be minused from the retail price

5. The Commission says that the costs of backhaul from the first ATM switch to the handover switch, from there to the access seeker's network, and then on to the internet (or another destination) are not costs that are avoided by Telecom in providing a wholesale UBS service. It concludes that these costs should not be minused from the retail price (para 100 of the Draft report).
6. In fact, Telecom faces similar sorts of costs in getting traffic from the first ATM switch out to the point in its network where it connects to the internet (or other destination). And these costs should be minused off because they are avoided by Telecom when a customer is supplied by an ISP using UBS rather than by Telecom directly.
 - The Commission's statement implies that where Telecom supplies a retail customer directly, it incurs no costs in backhauling of conveying traffic from the first ATM switch to its IP network and peering or transit points. This can not be true.

7. So while the Commission is right that there are some additional costs for competing ISPs using UBS that are not incurred by Telecom, it also must recognise that there are some backhaul costs for Telecom that *are* avoided by using UBS and that *should* be minused off.¹
8. The question for the Commission then is to figure out how these two sets of costs compare with each other.
9. This seems like a reasonably complex technical challenge because there are many choices about how to deliver backhaul and costs vary accordingly.
10. In addition, using Telecom's costs is unlikely to be appropriate in a theoretical sense if Telecom provides itself with a superior service than it supplies to access seekers. This appears to be the case: Telecom uses Ethernet backhaul rather than ATM, which may well involve lower costs than ATM backhaul.
11. In those circumstances, it would appear relevant to consider the costs likely to be incurred by a reasonably efficient competitor. The simplest and most relevant proxy would be to use the prices that Telecom sets for access seekers to backhaul traffic from the first ATM switch to the access seeker's network.
 - For Ihug's network this was estimated in June 2006 at around \$0.80 cents a customer for the leg from the first ATM switch to the handover ATM switch, and another \$1.12 from there to Ihug's network over the interconnect.
 - As well as being simple, this method has two useful additional properties. It will prevent price squeezes by definition, since it would be possible to buy products from Telecom at prices that allow efficient operators to compete. And it would also encourage Telecom to set reasonable prices for access seekers for backhaul.

Interconnect links

12. The Commission specifically indicates that the costs of interconnection links between the networks of Telecom and access seekers should not be subtracted from the retail price. As stated above, for Ihug these costs are estimated at \$1.12 per customer per month.
13. Although we agree with the Commission that the costs of interconnection are not avoided by Telecom when supplying the bistream access service, they should still be minused from the retail price.
14. If they are not, it would breach the principle the Commission states in paragraph 52:

¹ We also note that Telecom appears to support this cost deduction (albeit as part of a general deduction for ISP specific costs). In paragraph 21 of its submission on CallPlus's application, it notes that "Next a deduction should be made for the cost of backhaul".

“An equally efficient competitor should be able to use the bitstream access service to effectively compete with Telecom ...”

15. All ISPs must interconnect with Telecom to provide retail services, so all ISPs must face a cost disadvantage compared with Telecom. If the costs of interconnection are not subtracted from the imputed retail price, an equally efficient competitor will simply not be able to compete with Telecom.
16. This cost disadvantage could not be said to be a result of the efficiency of Telecom relative to its competitors, and allowing the disadvantage to persist would only limit competitive intensity between Telecom and entrants. By placing Telecom on an equal footing with competitors, the Commission will better achieve the overall objective of promoting competition for the long-term benefit of end-users.
17. Other regulators have considered this issue, and come to a similar conclusion.²
18. Note that there might be a legitimate objection to the removal of these costs if the underlying network charge for UBS were cost based. In that case, removing more than avoided costs from the retail price would result in Telecom not recovering its network costs. However, the nature of the retail-minus pricing methodology does not require Telecom’s UBS pricing to be cost-reflective. So we would not expect a deduction to significantly impact on Telecom’s network investment incentives.

Data costs

19. The Commission has asked for submissions on the costs of data transmission.

More than just international traffic

20. Most attention in the debate has been focused on the costs of carrying international internet traffic. This makes up the bulk of our traffic and most of our variable data costs, but it is not the only cost. So using only international data costs will underestimate actual data costs.
 - There are network costs associated with carrying data destined for points in our network, costs of domestic internet traffic, and, as referred to above, costs in getting international data across our network to and from the handover point to the international peering point.

The components of costs

21. We can think of data costs as being made up from the cost of data (\$/GB) and the volume of data (GB/month). The cost is the same across all plans, the volume varies by plan.

² See Ofcom consultation and final statement on the local call disadvantage at http://www.ofcom.org.uk/consult/condocs/cps_option/cps_statement

22. Although we endorse the Commission's apparent approval (paragraph 96) of the use of "prevailing market rates" for setting data costs, this still leaves open various options for estimation.
23. This is particularly important for two reasons:
 - The UBS price is sensitive to the data cost estimate, so the setting of this number has the potential to substantially affect access seekers' ability to compete.
 - We understand that on average access seekers' customers consume more data (as a percentage of the cap) than Telecom's customers. This could mean that data costs have a greater impact on access seekers than on Telecom.
24. Options would be to set these charges based on the prices that Telecom charges access seekers for international Internet traffic, or the prices that access seekers pay for this traffic. In either case, an allowance would be needed to be added to cover the costs of other traffic as mentioned above.
25. The question of estimating data volumes is more complicated. There are two obvious options:
 - Actual usage – This involves averaging out total usage across all users on each plan. We understand John de Ridder to be saying that this method understates the amount that should be minused off. This is because every plan will be priced on the basis that actual usage will be lower than the budgeted allowance for the plan.

The risk of customers exceeding this budgeted target will be transferred to access seekers, but there will be no reduction in the UBS price to reflect the risk. If we know that access seekers' customers are higher users on average, then we should be especially cautious about setting the data cost figure too low.
 - Cap allowance – This involves assuming that every user uses the maximum allotment on each plan. Some allowance would need to be made for plans that have no cap.

Other issues

Adjustments over time and imputation testing

26. We are not completely clear from the report how the adjustment process will work.
27. The Commission is proposing that the UBS price be reviewed any time Telecom updates its plans or prices. Telecom will be required to demonstrate that an equally efficient access seeker could compete using the regulated service, and to agree the new prices with access seekers, with recourse to the Commission should agreement not be reached.

28. Two things in this process are not clear to us:

- First, we are not sure whether this process will replace in its entirety the quarterly WARP adjustment, or whether there will continue to be a quarterly re-running of the model in order to account for changes in the mix of customers on Telecom's retail plans and for changes in data use.
- Second, it would be very helpful if the Commission could be clearer about what it intends in terms of imputation testing. This process can be a very challenging and contentious exercise and it is not exactly clear to us what the Commission expects Telecom to do or how that might help avoid price squeezes in the future.

If it is simply a question of Telecom being required to use the Commission's new methodology to demonstrate that new broadband plans do not fall foul of the price squeeze test, then it would be useful to say that clearly.

Backdating

29. We understand the Commission's logic for backdating to October; if it is reconsidering and replacing the old decision then it makes sense to replace it back to the first day that the new plans were put in place.
30. However, we are not as clear on why or how backdating would work before that date. Before October 2006 there was an entirely different UBS service with different plans (slower and with smaller data caps).
31. It would be helpful to have some clarity from the Commission on exactly how it intends this process to work.

Sensitivity testing

32. Regardless of the model the Commission settles upon in its final report, it would be helpful if it could perform some sensitivity testing of its key assumptions to see how they influence the final UBS price.
33. We expect there to be some disagreement amongst the parties about the best method to estimate the costs that should be minused from the retail price. One option might be for the Commission to run a series of scenarios to look at the impact of choosing different input values on UBS prices.

Conclusion

34. If you have any questions about this response, please contact either me (021 689 176, hayden.glass@vodafone.com), or David Diprose (021 275 0003, davidd@staff.ihug.co.nz).

Yours sincerely,

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