

UBA price calculation: comments on Telecom's proposed changes

Report for TelstraClear, 28 March 2011

Network Strategies Report Number 30030

Contents

1	Introduction	1
2	Outcome of the Commission's competition analysis	1
3	Case study: United Kingdom	3
4	Telecom's proposed changes to the UBA price calculation	6
5	Conclusion	6

1 Introduction

In its *Draft Review of the Standard Terms Determination for the designated service Telecom's unbundled bitstream access*¹ (Draft Determination) the Commerce Commission details its competition assessment for the unbundled bitstream access (UBA) service.

Telecom's subsequent submission² proposed several refinements to the proposed method and process, as well as making certain observations regarding practical changes to the UBA price calculation. These observations were expanded in a response³ to the Commission's request for clarification.

This short report outlines our view of Telecom's proposed changes to the UBA price calculation.

Although this report has been commissioned by TelstraClear, the views expressed here are entirely those of Network Strategies.

2 Outcome of the Commission's competition analysis

The Commission's preliminary view within the Draft Determination⁴ is that each of Telecom's exchange service areas (ESAs) – excluding lines that are cabinetised – forms a separate geographic market for wholesale broadband access, while for all cabinetised areas there is a single geographic market.

¹ Commerce Commission (2010) *Draft Review of the Standard Terms Determination for the designated service Telecom's unbundled bitstream access*, public version, 28 October 2010.

² Telecom New Zealand (2010) *Submission on the draft review of UBA STD – the competition assessment*, public version, 25 November 2010.

³ Telecom New Zealand (2011) *UBA price calculation: request for clarification*, March 2011.

⁴ Commerce Commission (2010) *Draft Review of the Standard Terms Determination for the designated service Telecom's unbundled bitstream access*, public version, 28 October 2010, paragraph 63.

Ofcom and the Australian Competition and Consumer Commission (ACCC) consider that exchanges with the incumbent and three other infrastructure-based providers are those likely to have effective competition⁵. However the Commission considers that a lower threshold is appropriate for New Zealand and proposes that the conditions for effective competition and the removal of regulation to be:

- two or more Competing Providers are present; or
- one UCLL-based Competing Provider is present and the exchange will serve at least 6500 non-cabinetised lines (after the cabinetisation deployment is completed).⁶

The Commission found that across ESAs with less than two UCLL-based Competing Providers, Telecom's market share was 98%, while if there were two or more Competing Providers Telecom's market share reduced to 76% (Exhibit 1). It should be noted that as there was no data available on an ESA basis for TelstraClear's cable subscribers, these figures exclude that segment of the market.

<i>UCLL-based Competing Providers:</i>	<i>Less than 2</i>	<i>2 or more</i>	<i>Overall</i>
Count of exchanges	525	43	568
<i>Copper broadband lines</i>			
Total	431 538	232 141	663 679
Telecom	423 335	177 294	600 629
Competing Provider lines	8 203	54 847	63 050
<i>Market share</i>			
Telecom	98%	76%	90%
Competing Providers	2%	24%	10%

Exhibit 1: *Market shares in ESAs with UCLL-based Competing Providers [Source: Commerce Commission]*

⁵ Ofcom imposes additional conditions, as described in Section 3.

⁶ *Ibid*, paragraphs 122–123.

The Draft Determination lists the 51 ESAs in which there are two or more UCLL-based Competing Providers, of which 71% (36 exchanges) are in Auckland. Only three exchanges – two in Wellington and one in Christchurch – are in areas that could have TelstraClear cable subscribers.

The Commission noted that there were 62 390 TelstraClear cable broadband subscribers in Wellington, Kapiti and Christchurch, and that TelstraClear has captured significant market share in areas with cable coverage.⁷

3 Case study: United Kingdom

In its 2010 review of the wholesale broadband access market, Ofcom concluded there were four separate geographic markets in the United Kingdom:

- Hull area – 0.7% of UK premises
- Market 1 – exchanges in which only BT is present (11.7% of UK premises)
- Market 2 – exchanges where two Principal Operators⁸ are present or forecast; and exchanges where three Principal Operators are present or forecast but where BT also has at least 50% market share (10.0% of premises)
- Market 3 – exchanges where four or more Principal Operators are present or forecast; and exchanges with three Principal Operators are present or forecast and BT's market share is less than 50% (77.6% of premises).⁹

Ofcom found that significant market power (SMP) was held by BT in Markets 1 and 2, and KCOM in the Hull area. No operator held SMP in Market 3.

⁷ *Ibid*, paragraph 131.

⁸ Not including BT.

⁹ Ofcom (2010) *Review of the wholesale broadband access markets: statement on market definition, market power determinations and remedies*, 3 December 2010.

Ofcom proposed differing regulatory remedies for Market 1 and Market 2. It should also be noted that over the four-year period 2006 to 2010 BT undertook a voluntary commitment to place a floor and ceiling on the ARPU of the wholesale broadband access product.

Market 1 – regulatory remedies

For Market 1, Ofcom noted:

In Market 1 there is limited prospect in the near term of any wholesale competition. Therefore we are imposing general access and non-discrimination obligations on BT, together with a requirement that charges should be based on the costs of provision. These obligations will ensure that other CPs [communications providers] have the opportunity to use wholesale products supplied by BT to compete effectively at the retail level. We are also imposing obligations requiring BT to publish information that provides transparency of the services it provides in Market 1. In relation to transparency of financial information we have decided that BT should be subject to an accounting separation obligation to provide transparency as to the services it provides to external CPs and to its own retail divisions and a cost accounting obligation to provide transparent cost data. The details of these obligations will be the subject of a separate consultation.

In addition we have decided that BT's services in this market should be subject to a charge control. This additional remedy, the details of which will be subject to separate consultation, is aimed at ensuring that BT does not set excessive prices which would ultimately be passed on to consumers.¹⁰

Ofcom's current consultation on charge controls for wholesale broadband access¹¹ proposes an RPI-X% charge control for a defined basket of services to apply for a three year period until 31 March 2014, with the value of X% to be within the range 10.75–14.75%. In addition Ofcom proposes RPI-0% sub-caps for several services within the basket.

¹⁰ *Ibid*, paragraphs 1.22 and 1.23.

¹¹ Ofcom (2011) *Proposals for WBA charge control*, 20 January 2011.

Note that the values of X% were determined from a cost model developed by Ofcom. During the interim period from the expiry of its voluntary commitment at the end of 2010, and while the wholesale broadband access charge control is being developed, BT is required to provide cost-oriented prices in Market 1.

Market 2 – regulatory remedies

In the case of Market 2, Ofcom noted:

BT also has SMP in Market 2 and so we have decided to impose general access, non-discrimination and transparency obligations for the same reasons as in Market 1 as set out above.

Given its position in the market there may be potential for BT to raise its prices to an excessive level. However, there is some wholesale competition in Market 2 and the potential for this to develop further, though the extent of any such further investment is uncertain. We consider that an approach to regulation that promotes investment where it is economic in order to provide effective and sustainable competition is appropriate in Market 2. However we also recognise that a safeguard to protect against the potential risk of prices rising to an excessive level is needed, in case this additional investment does not materialise. We think strict price regulation would not be appropriate to achieve this. Instead, we are imposing a cost orientation obligation which allows BT a greater degree of pricing freedom. As in Market 1, we have also decided that BT's services should be subject to accounting separation and cost accounting obligations to provide transparency of financial information.

The different approach we are taking in Market 2, compared to Market 1, is mainly due to our assessment of the likely constraint on BT's pricing arising from current and future investment by other operators. We have also taken account of the possible impact our regulation may have on prospects for future investment and on those providers that have already made investments in Market 2.¹²

¹² Ofcom (2010) *Review of the wholesale broadband access markets: statement on market definition, market power determinations and remedies*, 3 December 2010, paragraphs 1.24–1.26.

4 Telecom's proposed changes to the UBA price calculation

The pricing principle for the UBA service is retail-minus.

Telecom proposes that the regulated UBA price is set with reference to its retail prices in regulated areas only, rather than to its retail prices in all ESAs.

While certainly this approach has some merits, which are identified by Telecom, it could also introduce substantial risk, also identified by Telecom, namely:

- Telecom could inflate UBA prices in regulated ESAs by increasing the retail broadband price
- Telecom could also anti-competitively price wholesale services in deregulated ESAs.¹³

Telecom's current retail prices are becoming more complex, with the Total Home packages offering lower prices for customers in Auckland City, Wellington City and parts of Christchurch. With that precedent, Telecom could continue to offer cheaper retail prices in deregulated areas, while at the same time inflate the retail prices in regulated areas – that is, in areas where it has significant market power, and where there are fewer Competing Providers. High retail prices would flow through to high wholesale prices, increasing the entry barrier in those ESAs for competitors. The effect on consumers in regulated areas would be higher prices and less choice – surely an outcome that regulation aims to prevent.

The underlying problem is that the retail-minus pricing principle will not lead to the benefits of competition if the original retail prices do not reflect the costs of an efficient operator and indeed discourage entry by competitors – which may well be the case in areas where competition is limited.

5 Conclusion

Unlike the situation in the United Kingdom, where Ofcom defined three markets – with different regulatory remedies – representing ESAs with no competition, some competition,

¹³ Telecom New Zealand (2011) *UBA price calculation: request for clarification*, March 2011.

and sufficient competition to justify deregulation, the New Zealand areas subject to regulation are a mix of ESAs with no competition and some competition. Ofcom is further proposing regulatory remedies that ensure that wholesale prices in regulated areas are either cost-oriented, or are approaching cost-oriented rates.

These mechanisms are not currently available to the Commission, and thus it would not be able to prevent Telecom inflating retail prices in regulated areas either as a barrier to competition in those areas, or to cross-subsidise low prices in deregulated areas.

It is essential to ensure that application of a pricing principle does not have the opposite effect from its intention – namely to ensure consumers in regulated areas reap the benefits of competition where that competition does not exist or is immature. As the Commission has limited ability with the retail-minus pricing principle to prevent potential anti-competitive behaviour, it should reject Telecom's proposal for setting the regulated UBA prices with reference to Telecom's retail prices in regulated areas only, rather than to its retail prices in all ESAs.