

Version FINAL

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Submission:

**Comments on the Accounting
Separation Consultation Document**

April 2010

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Introduction

Thank you for the opportunity to comment on the consultation document on Accounting Separation.

While there is a regulatory requirement for accounting separation for Telecom, this is not useful to new entrants or the regulators as it could or should be. The current model does little to assist in understanding Telecom's business models and costs, and nothing to assist the regulatory process to create competition.

Overview – 2degrees' position

We believe that the accounting separation requirement needs further work and development, and should be expanded upon to encourage investment in NZ and encourage appropriate regulatory scrutiny ..

It is disappointing to see no specific break-out of mobile phone services or mobile backhaul in the consultation document. 2degrees believes that new investment in mobile services is, as if not more essential as the investment in new fixed line services. Mobile is where New Zealand consumers are looking for a better deal.

We believe that all operators with market power should be required to submit regulatory accounting disclosure. We believe that it would serve section 18 of the Telecommunications Act if all operators – including backhaul operators Kordia and Vector, and mobile operator Vodafone – filed regulatory accounts pursuant to part 2B of the Telecommunications Act.

2degrees agrees with the Commission that comprehensive disclosure and analysis would promote a greater understanding of the operations of Telecom and its network and wholesale activities. In turn, this disclosure would help mobilise capital and resources to invest in infrastructure in NZ.

We believe it is the intention of this requirement to highlight which part of the business is the easiest to start providing competition to, and which bottlenecks need regulation to promote competition.

It appears that there are few users of the regulatory accounts other than the Commission and the financial analysis community (Goldman, Merrill, Forbar, Craigs, CSFB, etc). If the accounting separation and disclosure requirements were a success, every new entrant infrastructure investor would be reading them and submitting consultation comments.

In NZ there is a substantial information deficit which is frustrating competition and regulation focus. The main deficits are as follows:

- Full accounting information and disclosure of the incumbent mobile operator Vodafone
- No break-out of the Telecom mobile from Telecom retail
- No break-out numbers highlighting actual Telecom Mobile expenditure on infrastructure CAPEX and also Telecom expenditure on handset subsidies and retail facilities, expenditure which is often used to create a barrier to entry.
- No financial break-out of important mobile infrastructure such as cell towers and backhaul
- No official review of market share by revenue, or break-out of market share by geographic region

The Regulatory purpose of Accounting separation & disclosure

We believe that Accounting statements should have a clear purpose and that the commission should produce a mission statement to better define the purpose of this expensive and time-consuming process.

2degrees believes the goal of the accounting separation should be:

- to prevent any potentially unlawful bundling of products, thereby blocking individual product investors;
- to assist in allocating capital expenditure by new infrastructure investors;
- to provide a road map for products and service costs within telecom;
- to identify bottlenecks and ensure that they are efficiently priced;
- to address the impact and creation of any monopoly rents; and
- to identify barriers to entry (for example, hidden handset subsidies).
- to identify new investment opportunities in NZ

We believe EBITDA numbers need to be produced at a category level, including the wireless business, ADSL/fixed line business, and backhaul business.

We also believe that the interplay between Telecom wholesale, Chorus, and Telecom retail needs to be more clearly explained.

Traffic patterns need to be disclosed as part of a workable accounting and disclosure regime

The Regulatory Regime

2degrees believes that the regime needs to be adjusted to take into consideration key mobile phone industry issues:

- cell towers
- backhaul
- CAPEX (net CAPEX after depreciation before retail and handset subsidies)
- naked ADSL costs should be more visible (this will support fixed to mobile substitution)

Comments on Proposed changes

| Issue | Proposed Change | 2degrees' Comment |
|---|---|---|
| <p>Regulatory Accounting Principles</p> <p>Absence of a unified set of regulatory accounting principles.</p> | <p>Prescribing a full set of regulatory accounting principles to be included in Telecom's regulatory reporting manual</p> <p>Requiring Telecom to apply these principles when preparing the regulatory financial statements.</p> | <p>Some areas should be highlighted, particularly in mobile bottleneck access services – and where there is a fully competitive market, no disclosure should be required</p> |
| <p>Regulatory Financial Statements</p> <p>Experience from 2009, identified areas where the regulatory financial statements could be improved</p> | <p>Improving the presentation of the regulatory financial statements by simplifying the content and format:</p> <p>Adding an Introduction, a Basis of Preparation and a Commentary to the Regulatory Financial Statements</p> <p>Summarising the Regulatory Statement of Financial Performance; Notes to the Regulatory Financial Statements to include the detail</p> <p>Refining the Product Statements to align with the Regulatory Statement of Financial Performance</p> | <p>A break-out section for mobile is required</p> <p>Cell towers and mobile backhaul should have their own break-out section</p> <ul style="list-style-type: none"> • Mobile CAPEX should be broken out into • net CAPEX after depreciation • handset subsidies • backhaul • retail store investment |
| <p>Regulatory Audit Requirements</p> <p>The regulatory audit opinion is currently required to be in the form 'prepared in all material respects in accordance with these Requirements'</p> <p>The revenue audit materiality level is currently set at 1%.</p> | <p>Changing the audit opinion to be 'as prepared in all material respects in accordance with the regulatory reporting manual' to remove the need for the auditor to comment on compliance with the Requirements</p> <p>Increasing the revenue audit materiality level to 2% to reduce the regulatory audit workload while still providing an adequate level of assurance</p> | <p>We believe its important that divisional costs and product costs are accurate, this will help competition and assist in identifying the best areas to invest in infrastructure</p> <p>The audit procedures should not be unreasonable on Telecom – as these telecom audit costs are later passed to the entire industry through wholesale access costs</p> |
| <p>Change Management Process</p> <p>There is a need to understand the impact of changes to the regulatory financial statements.</p> | <p>Requiring Telecom to have a documentation process to track the implementation of any changes.</p> <p>Publicly disclose changes which have a material effect on the regulatory financial statements</p> | <p>We believe its this area the Commission needs to be more prescriptive. The large integrated business of Telecom has been used to confuse competition and reduce visibility of independent business units</p> |

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| | and help readers understand the effects of changes. | No better example of this is than Mobile – Where in 2006 the company stopped producing EBIT numbers for and there is no material business unit accounting for this business |
| Regulatory Reporting Manual Telecom’s inclusion of background material in the manual was useful for readers, but was not formally required. | Requiring Telecom to include an introduction, glossary of regulatory terms, and a technical dictionary in its regulatory reporting manual. | These need to be shrunk and made simpler We are unaware of any competitors or service purchasers who actually use this material to guide them around the Telecom business |
| Publication Date Establish a closer alignment of publication dates for Telecom’s regulatory financial statements and the Commission’s summary and analysis | Deferring the publication of the 2010 regulatory financial statements to 31 March 2011 to align with the publication of the Commission’s summary and analysis | The timing is not as important as the simplicity |

Summary of Key Points

- There is a need to review the usefulness of the information produced by Telecom generated by the Accounting Separation and accounting disclosure.
- More detailed analysis of the wireless mobile business and its relevant is required plus would promote investment in the sector
- New infrastructure investors and builders are not using the accounting separation information in the way it was intended to be used. This suggests the need for a thorough re-think of what information is useful.

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