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**The Telecommunications Regulatory Regime:
An Overview**

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I'm glad to have the opportunity today to speak to you about the telecommunications regulatory regime from the perspective of the Commission. Other sessions will explore elements of the regime and I am looking forward to hearing the views of those speakers. Though the program describes the regime as "new", both the regime and I are ageing fast.

In starting, I will sketch out the nature of the regime and the way in which the Commission is organised to handle it. Next, I will explain in more detail some of the major activities we have underway at present. Finally, I want to describe the regulatory decision making process.

The driver for the regulatory regime, in the language of the Telecommunications Act, is the promotion of competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand. The regulatory regime compensates for weaknesses in the competitive environment where incumbents are vertically integrated, and are competing in related markets with new entrants. Regulation should be a spur to innovation and efficient investment by neutralising incentives to use market power.

The regulatory regime has three principal functions:

- The first is resolving disputes relating to both price and non-price terms between industry members as they relate to a variety of key telecommunications services. While the highest profile disputes are those concerning the terms of interconnection

between Telecom's fixed network and the networks of other companies, access disputes can also relate to the terms on which other companies may wholesale Telecom's products, and the terms on which new cellular mobile operators may use the infrastructure of their competitors to support national roaming.

- The second is monitoring the performance by Telecom of its Telecommunications Service Obligations concerning the availability, price and standard of local voice and dial-up internet services, calculating the net cost of the TSO and allocating the net cost across the industry. This represents a significant shift from the status quo, and will result in firms whose networks are interconnected with the Telecom fixed network and who provide services in New Zealand to end-users contributing to the TSO net cost in proportion to their revenues.
- The third is maintaining the dynamism and flexibility of the regulatory system by recommending to the government from time to time, changes in the list of regulated services, either adding, modifying, or deleting as appropriate.

The Telecommunications Commissioner is a member of the Commerce Commission and shares general governance and decision-making responsibilities. In addition, of course, the Telecommunications Commissioner has specific telecommunications responsibility and authority. The Commissioner is independent from both government and industry and is appointed for a fixed five year term.

The Commission's telecommunications activities are funded in two ways. Its dispute resolution functions are funded directly by the parties to each dispute, with the Commission able to impose full cost recovery. For its other functions, the Commission relies on appropriations from government, funded ultimately by levies on the industry. The levy cannot exceed the appropriation.

Within the Commission, there is a dedicated telecommunications team, supplemented by specialist consultancy advice as necessary. On key pricing and TSO issues and when making recommendations for changes to the regulatory regime, the Commissioner sits with two other Members of the Commerce Commission. Otherwise, the Commissioner acts alone.

Accountability is an essential counterpart to independence and in the case of the telecommunications regime there are several levels of accountability. We are following a

practice of consulting widely with stakeholders on the principles to be followed under the regime. Our decisions can be appealed to the High Court on a question of law, with the possibility of a further appeal to the Court of Appeal. The appropriations process allows officials to examine the telecommunications' work plan and the match with the funding requested. Finally, the Commission's Annual Report provided to Parliament describes what has been achieved and how the resources have been applied.

There is an industry self-regulatory component of the regime. Industry participants have established an industry forum to bring together large and small telecommunications companies and also the Telecommunications Users Association of New Zealand, to discuss technical interconnection standards between networks. The forum may develop industry codes, which once approved by the Commission, become binding on the industry.

In making decisions on access disputes, the Commission may have to determine the price to be paid for services and potentially the non-price terms to the extent that the parties cannot agree on them. Price is obviously a controversial issue. Generally speaking, interconnection prices are to be cost-based. They should also be forward-looking and cover the incremental costs of the service as well as a share of common costs and a reasonable return on capital. Wholesale prices will be stipulated as a discount off retail prices.

The Commission has before it an access dispute between TelstraClear and Telecom New Zealand, each of whom sought determinations from the Commission. The terms and conditions in dispute include the price of interconnection between the two fixed networks, the level of discount available for wholesale services and a range of non-price issues. The Commission has already made some threshold decisions in relation to the dispute. At an early stage, the Commission separated the TelstraClear application into two streams, interconnection and wholesale services. The Commission also decided that the issues raised in the two applications lodged by Telecom could be dealt with in the context of the TelstraClear application without disadvantaging Telecom and that accordingly there was no need for the Commission to deal with the separate Telecom application.

One feature of the New Zealand regulatory environment is the continued importance of commercial negotiations as a means of resolving disputes. Before the Commission commences an investigation into the dispute, it must consider whether the applicant for a

determination has made “reasonable attempts” to negotiate the terms of supply of the service in question.

The nature of the negotiation process between an incumbent owner of the national fixed network and a competitor seeking access to that network is somewhat different from that between two competitors neither of whom enjoys market power. In the former case, there are several features of the negotiating environment that are important in relation to the regulatory regime:

- ❑ The incumbent may present a template interconnection offer, leaving the competitor to seek changes at the margin;
- ❑ The pace of negotiation is largely controlled by the incumbent;
- ❑ The prices for major elements of the access service are specified, but without material justification other than perhaps unquantified references to prevailing practices in the marketplace;
- ❑ The incumbent may be unwilling to make concessions except as part of a full settlement, therefore making all issues dependent on the most difficult one to resolve.

Though this dynamic is in theory counter-balanced by the reciprocal nature of access negotiations, with the access terms for the national network mirrored for access to the competitor network, in practice the incumbent’s terms become the de facto standard.

In considering whether an access seeker has made reasonable efforts to negotiate, the Commission will have regard to these asymmetric elements in the negotiation process.

The Commission has considered a number of factors in the TelstraClear interconnection application in relation to the reasonableness of the negotiation attempts:

- ❑ The existence of previous interconnection agreements as a basis for common understanding;
- ❑ The exchange of specific proposals between the parties;
- ❑ Evidence of ongoing meetings and attempts to clear away high level issues;
- ❑ The involvement of senior management in the discussions;
- ❑ A focus on the most significant issues during negotiations; and

- The provision of a rationale for negotiating positions.

The Commission concluded that TelstraClear had met the “reasonable attempts” threshold for interconnection and some wholesale services. However, the Commission also found that for some wholesale services, there was insufficient evidence of negotiation, and it declined to investigate those services.

This last point underlines the statutory scheme requiring a responsibility to negotiate effectively before turning to the regulatory alternative. Regulatory outcomes are not cost-less and the risk of gaming the process is reduced by requiring that a real effort be made to find a bilateral solution. Even after the Commission has decided to investigate a dispute, the parties are encouraged to continue to negotiate. The applicant can at any time withdraw the application, and the Commission will cease the determination process.

The timetables set by the Act for the regulatory decision-making process also strengthen the incentives for continuing negotiation. Both parties know that once the process is underway, the Commission will be preparing a decision that becomes binding on the parties once issued. In other words, the parties are faced with a rather rapid deadline when their ability to control outcomes will be ending. The determination has the effect of a judgment of the High Court and is enforceable through the Court by either party.

The Commission does not have any illusions that it is in a better position than the parties to decide on the commercial terms for their relationship. But the Commission’s power to make a binding decision if the parties cannot agree ensures that the best does not become the enemy of the good. An indefinitely postponed negotiated outcome may not be superior to an early and certain regulatory outcome.

The risks of a “wrong” regulatory decision are minimised by several factors:

- The parties have the chance to present detailed evidence and arguments to the Commission in advance of a decision;
- Where there are others in addition to the parties who have a material interest in the dispute, the Commission will either consult with them or hold conferences to allow them to present their views;

- ❑ Either party can appeal to the courts against a determination, though as I have mentioned the appeal is limited to a question of law and does not involve a rehearing of the Commission's decision on the merits;
- ❑ The period of a determination is limited. The Commission is conscious of the rate of change in this industry and wishes to avoid locking-in a sub-optimal solution for a long period of time, even if that decision was right at the time it was made;
- ❑ Either party can reopen a pricing decision within 15 working days by requesting that the Commission carry out a review of the initial price through the application of a more elaborate final pricing methodology; and
- ❑ The Commission may be asked in the future to clarify, revoke or amend a determination and make a replacement determination.

So there appears to be a reasonable balance struck in achieving an outcome that places a premium on promoting the interests of end-users through breaking the log jam on settling access terms for key telecommunications services.

The Commission has a wide discretion in relation to the procedures it follows when investigating a dispute. In particular, the Commission is not bound by technicalities, legal forms, or rules of evidence. While the Commission is in control of its own procedures, we have consulted with TelstraClear and Telecom on a schedule for the process going forward. Part of the agreed procedures has been the use of workshops for the parties with Commission staff in order to clarify issues in dispute, and where possible to narrow the scope of the dispute. Generally speaking, the parties have agreed that this is a helpful way to proceed. We have decided to issue a draft decision – a step not specifically required by the Act – to enhance the effectiveness of the consultative process. We are also seeking the views of other carriers and interested parties on key aspects of the draft decision through their participation in a conference to be convened by the Commission. The Commission will consider the submissions made during these processes before making its determination.

The two-stage process involving an initial determination, followed by a pricing review if requested by one of the parties, relies upon price setting at the first stage through the use of benchmarking against interconnection prices in other countries. Benchmarking requires that prices be identified for countries that:

- ❑ are comparable to New Zealand;
- ❑ have networks that are similar to the Telecom fixed voice network; and
- ❑ use forward-looking cost-based pricing.

Later today, I see that there is a session on the pros and cons of benchmarking in telecommunications. As part of its preparatory work, the Commission has released an approach paper on benchmarking and has held a two-day conference. Benchmarking has certainly not proven to be quick or simple. A wide variety of pricing structures make comparisons difficult. At the network and country level, the factors relevant to measuring comparability are contentious, as is adjusting the data for meaningful comparison with New Zealand. Once the benchmark range has been identified and converted to a common currency unit, there remains the challenge of using the resulting wide range to select a New Zealand price.

Whether or not the Commission will need to fix a benchmarked price in the Telecom-TelstraClear interconnection dispute will depend upon a discretion that the Commission has under the Act to decide that interconnection prices should be set relying upon a bill and keep method, where each carrier would bear its own costs of terminating traffic originating on the other network. Pure bill and keep would mean that each company ‘takes in its own laundry’, and there are no interconnection payments to be exchanged. The Commission would choose bill and keep if it considered that a forward-looking cost-based pricing method did not best give effect to the purpose of the promotion of competition for the long-term benefit of end-users. One traffic type where bill and keep would not seem appropriate would be toll bypass, since the bypass operator may not originate or terminate the calls. There appears to be a stronger case for bill and keep in regard to data calls, where payment of termination charges may provide inefficient incentives to expand Internet traffic.

Benchmarking is also used in setting initial prices for some wholesale discounts. The benchmark is again “comparable countries”, though regulated wholesale discounts are found only in the United States and Australia, so the potential sample set is small.

In the meantime, work is continuing on the costing of the Telecommunications Services Obligation. Following a public conference in early July, the Commission made a number of

threshold decisions about the proposed methodology for assessing the net cost to Telecom of complying with the TSO.

The net cost of complying with the TSO has been hotly debated within the industry, as it has been in other jurisdictions with a universal service model. The basic concept is one of identifying the costs of an “efficient service provider” of providing TSO services to commercially non-viable customers. This raises the question of the relevance of Telecom’s actual costs, perhaps adjusted by some efficiency factor, as distinct from the costs of a notional efficient operator. There are a variety of views on this fundamental point. One contention is that Telecom’s actual costs are irrelevant, as those costs reflect past investment decisions that may or may not have been efficient. The proposition is that Telecom should only be compensated for the costs that would be incurred today with knowledge of the current levels of demand for services and using the best available technology.

The competing view is that Telecom has had incentives to be efficient in providing TSO services. Any residual inefficiency can be accounted for by applying an efficiency factor derived from a comparison of Telecom’s operating performance with that of other “best in class” carriers.

The Commission is looking into building its own cost model of the Telecom network to support its net cost calculation. Such a model would be “bottom up” – that is, an engineering model created to estimate what an efficient cost benchmark for the provision of those services would be. It would also be a “scorched node” model – the existing locations of the Telecom network nodes would be retained, although the technology in use at the nodes would be optimised, as would the access network. The Commission is currently assessing the responses to its request for proposals for modelling the network and expects to announce decisions in the near future.

The TSO costs are to be offset by deduction of the direct and indirect revenues and associated benefits derived from providing telecommunications services to those commercially non-viable customers (i.e. a wider class of services than the TSO services themselves), netted for the costs of providing those services. There are issues as to which revenues are included by this definition, and of course as to the identification of the non-viable customers themselves.

Then there is the question of intangible benefits associated with being the TSO provider and how they are to be measured.

The relevant costs are to be the unavoidable incremental costs of providing the service, including a reasonable return on the incremental capital employed for the purpose. So costs associated with business decisions rather than the requirements of the TSO instrument are out and a return on capital is in (which raises the difficult issue of the measurement of the asset base).

The Act sets a demanding timetable for the Commission to make its initial decision on costing the TSO for the 2001/02 financial year. We need to finalise our modelling approach, collect the necessary data, and make reasonable efforts to issue a draft decision by December of this year, followed by a final decision by March next year.

A few comments on the way in which the Commission goes about making decisions under the regime. First of all, we have issued a series of draft position papers to explain our initial thinking on the approaches to be taken. I've already referred to the discussion papers on benchmarking of interconnection prices and on the TSO net cost calculation. There have been other papers on procedure, on interconnection pricing methodologies, and yet to come is a paper on wholesale pricing. These papers have stimulated an active debate with the industry, and the Commission has been helped by submissions and expert evidence provided to it.

We are talking to regulators in other countries and looking at the ways in which they have dealt with similar issues. At the same time, the limits of overseas experience are obvious. Different features of the ways in which telecommunications is organised and regulated in different countries have to be taken into account. While there is some convergence of regulatory policy in major markets, there are still significant differences between countries. The Federal Communications Commission in the United States in particular began moving earlier than many European jurisdictions towards cost-based pricing for access. Differing social policies can also affect comparability. For example, not many countries have free local calling as an industry standard.

The New Zealand regime itself has been shaped with an eye to best practice from other regimes. The use of initial and final pricing principles for example coupled with a timetable

for each step of the way represents a trade-off of some flexibility and discretion for predictability and speed.

In dealing with access disputes, the Commission is generally following its normal procedures that have evolved in the context of the Commerce Act. The Commission is able to use its mandatory information-gathering powers and to provide the protection of confidentiality orders where appropriate.

Beyond the access disputes and the TSO exercise, coming up at the end of the year are mandatory reviews of the case for regulating unbundling of the local loop and Telecom's Public Data Network. Under the Act, these reviews cannot commence before the first anniversary of the Act – December 2002, and must be completed by the second – December 2003.

In conclusion, the regulatory regime is facing a heavy workload over the next few months as it works through for the first time several interconnection and wholesale services disputes, and performs the first net cost calculation and allocation for the TSO. The Commission intends to continue to be as open as possible about the process it is following subject to the constraints of commercial confidentiality and the need for some shelter at the decision making stage. There is also a need for the self-regulatory component of the regime, the Industry Forum, to move beyond its establishment phase and to begin hammering out technical standards relating to access services. The Commission would like to rely on the Forum to develop industry solutions for the implementation of cost-based network access within the framework of the principles contained in the Act and the Commission's decisions on access disputes. There is an opportunity for cooperative resolution of some long-standing problems and the Commission intends to do what it can to encourage these outcomes while being ready to decide matters itself if asked to do so. The challenge for both industry and the Commission is to achieve what has been described as "finding the best possible mix of inevitably imperfect regulation and inevitably imperfect competition".