



## COMMERCE COMMISSION

### **Final Report on the Initial Pricing Principle for “Bundle of retail services offered by means of Telecom’s fixed telecommunications network”**

Final Report under clause 4 of Part 1 of Schedule 3 of the Telecommunications Act 2001 (“the Act”) in the matter of amending the initial pricing principle for “Bundle of retail services offered by means of Telecom’s fixed telecommunications network.”

**The Commission:**

Douglas Webb  
Paula Rebstock  
Donal Curtin

**Summary of Final Report:**

The Commission gave public notice on 27 February 2003 of its decision to investigate whether to recommend an amendment to the initial pricing principle of the designated service, “bundles of retail services offered by means of Telecom’s fixed telecommunications network.” This followed a request to investigate this matter by the Minister of Communications pursuant to Part 1 of Schedule 3 of the Telecommunications Act 2001. On 1 May 2003, the Commission issued a draft report. This final report sets out the Commission’s proposed alteration to the initial pricing principle and the Commission’s recommendation in respect of that proposed alteration.

**Date of Final Report:**

14 August 2003

<p><b>CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS</b></p>
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## **LIST OF ABBREVIATIONS**

FPP	Final Pricing Principle
FTN	Fixed Telecommunications Network
IPP	Initial Pricing Principle
TSO	Telecommunications Service Obligations means in this report the particular obligations prescribed by the Telecommunications Service Obligations Deed for Local Residential Service agreed between Telecom and the Crown.

## INTRODUCTION

1. On 27 February 2003, the Commerce Commission (“the Commission”) gave public notice of its decision to commence an investigation under Schedule 3 of the Telecommunications Act 2001 (“the Act”) into whether or not to recommend to the Minister of Communications an amendment to the initial pricing principle for “bundles of retail services offered by means of Telecom’s fixed telecommunications network.”

## REQUEST BY THE MINISTER OF COMMUNICATIONS

2. Pursuant to Part 1 of Schedule 3 of the Act, the Commission received a request from the Minister of Communications on 30 January 2003 to commence an investigation to determine whether the initial pricing principle (“the IPP”) of the designated service “bundles of retail services offered by means of Telecom’s fixed telecommunications network” should be amended.
3. Under clause 1(1)(a) of Schedule 3 of the Act, the Commission has discretion as to whether to commence an investigation depending on whether it is satisfied that there are reasonable grounds to do so.
4. The Commission was satisfied that reasonable grounds to commence an investigation existed and notified the Minister accordingly. The Commission gave public notice of its decision to investigate on 27 February 2003.<sup>1</sup>

## COMMISSION PROCEDURES

5. The Commission’s procedure in making a recommendation to the Minister of Communications is governed by Part 1 of Schedule 3 to the Act. Clause 1 of that Schedule states that:

### 1. Commission's investigation

- (1) The Commission may, on its own initiative or if requested to do so in writing by the Minister, commence an investigation into whether or not Schedule 1 should be altered in any of the ways set out in sections 65 to 67 (the **proposed alteration**) if:
    - (a) the Commission is satisfied that there are reasonable grounds for an investigation into the matter; and
    - (b) in respect of an alteration of a kind set out in section 65, it is not less than 1 year before the expiry of the service.
  - (2) If an investigation has been requested by the Minister and the requirements set out in subclause (1)(a) and (b) have been met, the Commission must commence the investigation not later than 10 working days after receiving the Minister's written request.
  - (3) The Commission must give public notice of the commencement of the investigation.
6. Clause 2 of Part 1 of Schedule 3 of the Act provides that, after public notice has been given, the Commission must prepare a draft report and publicly invite submissions on it. On 1 May 2003, the Commission issued a draft report and sought submissions.

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<sup>1</sup> New Zealand Gazette, 27 February 2003, page 497

7. The Commission received submissions from Telecom New Zealand Limited (“Telecom”) and TelstraClear Limited (“TelstraClear”) on 30 May, and from CallPlus Limited (“CallPlus”) on 13 June. TelstraClear and Telecom made cross-submissions on 19 June and 20 June respectively.
8. Clause 3 of Part 1 of Schedule 3 provides for the Commission to hold a conference in relation to the proposed alteration or a public hearing if the Commission is satisfied that it is in the public interest to do so. However, the Commission may dispense with this step if the amendment is of the kind listed in section 66(c) of the Act, which includes amendments to the applicable initial pricing principle. The Commission decided to exercise its discretion not to hold a public hearing or a conference in relation to the proposed alteration.
9. Schedule 3 of the Act enables the Commission to recommend to the Minister whether to add, omit or amend aspects of each designated or specified service following an investigation. This includes recommending an amendment to the pricing principle for each of the services within Schedule 1 of the Act.
10. In making its recommendation (or in making other determinations or decisions under the applicable part of the Act), the Commission must:
  - Consider the purpose set out in section 18 of the Act;
  - If applicable, consider the additional matters set out in Schedule 1 regarding the application of section 18; and
  - Make the recommendation, determination or decision that the Commission considers best gives, or is likely to best give, effect to the purpose statement set out in section 18.
11. Section 18 of the Act states that:
  - (i) the purpose of this part and Schedules 1 and 3 is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand by regulating, and providing for the regulation of, the supply of certain telecommunications services between service providers
  - (ii) In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand, the efficiencies that will result, or will be likely to result, from that act or omission must be considered.
12. Clause 4 of Part 1 of Schedule 3 of the Act requires that:
  - 4. Final report of recommendation of Commission**
    - (1) The Commission must make reasonable efforts to do the following things not later than 120 working days after the date of giving public notice under clause 1(3):
      - (a) prepare a final report regarding the proposed alteration;
      - (b) deliver the report to the Minister.
    - (2) In preparing the final report, the Commission must consider –
      - (a) all submissions made on the draft report; and
      - (b) all information and opinions presented or expressed at the public hearing (if any) on the draft report.
    - (3) A final report must include –
      - (a) the details of the proposed alteration; and
      - (b) a recommendation by the Commission as to –

- (i) whether or not the proposed alteration should be made;
- (ii) in the case of a proposed alteration to a designated service, whether or not the Minister's decision regarding the proposed alteration should be deferred for any period that the Commission thinks fit; and
- (c) the reasons for the Commission's recommendation; and
- (d) the views of 2 members of the Commission (other than the Telecommunications Commissioner) regarding the recommendation.

## THE VIEWS OF TWO MEMBERS OF THE COMMISSION

13. Under clause 4(3)(d) of Part 1 of Schedule 3, the final report must include the views of two members of the Commission (other than the Telecommunications Commissioner) regarding the recommendation. Commissioner Rebstock and Commissioner Curtin concur with the views in this report and its recommendation.

## INITIAL PRICING PRINCIPLE FOR A BUNDLE OF RETAIL SERVICES

### The IPP for Bundles of Services

14. Each designated service in Schedule 1 has a separate Initial Pricing Principle or IPP.
15. The IPP for "bundles of retail services offered by means of Telecom's fixed telecommunications network" is as follows (emphasis in italics added):

The wholesale price for the bundle is the amount calculated in accordance with the following formula:

- (a) first, —

$$a \times \left( \frac{100 - b}{100} \right) = c$$

where —

*a* is the retail price for the bundle

*b* is the discount (as a percentage) off the retail price for the bundle. The discount must be benchmarked against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries

*c* is the wholesale price

- (b) second, if Telecom's price-capped residential access and calling service is included in the bundle, deduct from *c* a discount of 2% of the standard price

16. In terms of combinations of price-capped and non price-capped products or services, three types of bundle are possible:<sup>2</sup>

- I. A bundle of services that are all non price-capped;
- II. A bundle of services that are all price-capped services; and

<sup>2</sup> The following uses the term "services" as shorthand to refer to both products and services.

III. A mixed bundle of non price-capped and price-capped services.

17. For bundles of type I, the formula and text in the current IPP reproduced in paragraph 15 sets out the consideration to be applied in deriving  $b$ , i.e. benchmarking against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries.
18. For bundles of type II, the IPP for the designated access service “residential local access and calling service offered by means of Telecom’s fixed telecommunications network” would apply.<sup>3</sup>
19. However, a concern arises in respect of the IPP for type III (mixed service) bundles. Taking a literal or plain meaning, the formula in the Act reproduced in paragraph 15 may be interpreted as:
  - $c$  can only be derived by applying the discount  $b$ ;
  - the discount  $b$  can only be derived by benchmarking against discounts applied to comparable bundles overseas that do not include price-capped residential access and calling service; and
  - the second part of the formula at (b) must be applied as an additional step. That is, if the bundle includes price-capped services, there is an additional deduction from  $c$  of 2% of the standard price to derive the wholesale price for the entire bundle.
20. To explain this interpretation further, the formula applies a discount to the retail price of the entire bundle (benchmarked against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries) to determine the wholesale price. However, if a bundle also includes price-capped residential access and calling service, the formula then applies an additional discount of 2%. This amounts to the application of a double discount to any bundle that includes price-capped residential access and calling service.

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<sup>3</sup> It is possible for type II bundles to exist in future that include price-capped services other than “Residential local access and calling service offered by means of Telecom’s fixed telecommunications network” (FTN). This scenario could arise if the Minister of Communications were to re-negotiate the TSO deed and/or apply price caps to services in the future other than residential local access and calling service offered by means of Telecom’s FTN (see paragraph 23 of the TSO deed). In this scenario, one might expect the IPP under investigation to apply. However, the Act does not appear to provide for this as price-capped services in the IPP in question are limited to “price-capped *residential access and calling service*” (emphasis in italics added). Were the IPP in question to apply, however, it would require the Commission to benchmark the discount against discounts applied to comparable bundles that do not include price-capped residential access and calling service(s) in comparable countries. It would not be reasonable to derive a discount for price-capped services by benchmarking against non price-capped services (see also the section below on ‘Lack of justification for the IPP approach’).

#### **Example: IPP for Bundles of Retail Services<sup>4</sup>**

Assuming a bundle sold at \$100

Benchmarked discount  $b = 16\%$

$c = \$100 \times ((100-16)/100) = \$84$

Standard price of price-capped service = \$40

Discount on price-capped service of 2%:  $((40 \times 2)/100) = 0.8$

Regulated wholesale price for bundle =  $\$84 - 0.8 = \$83.2$

21. Hence, there are two effects resulting from the current drafting of the IPP:
- The two discounts are not applied separately. More intuitively for a mixed bundle, one would expect that the benchmarking against non price-capped services under  $b$  would only be applied to the non price-capped services within a mixed bundle and that (b), (i.e. the 2% figure), would only apply to the price-capped residential access and calling service within the bundle.
  - Discount (b) (i.e. the 2% figure) is applied to the derived wholesale price  $c$  for the entire bundle i.e. *after* the discount  $b$  has already been applied. Hence for bundles containing price-capped residential access and calling service, the discounting is compounded.

#### **PROMOTING COMPETITION FOR THE LONG-TERM BENEFIT OF END-USERS**

22. The Commission considers that the effect of the IPP as it is drafted is not consistent with the purpose statement of the Act by applying a double discount to bundles that include price-capped services.
23. The reasons for this fall into two main categories:
- Lack of justification for the approach under the IPP; and
  - Lack of consistency with other IPPs in the Act and the Final Pricing Principle ("FPP") for bundles of retail services.
24. Both of these effects have the potential to distort incentives in a way that could be inimical to static and dynamic efficiency. These categories are explored in turn below.

#### **Lack of justification for the approach under the IPP**

25. The IPP formula in question mixes two different units of analysis - entire bundles and individual services within those bundles - given that it appears to provide for different treatment of those different types of service, (i.e. price-

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<sup>4</sup> In this example, provided in the interest of clarity, the benchmarked discount applied to the bundle of services is set at 16%. This figure is used merely to demonstrate the relationship of the various alternative approaches, and does not indicate the Commission's preference, or the likely outcome of an application for determination on bundles of retail services.



capped and non-price capped services). Therefore a straightforward application of the formula does not seem to lead to reasonable results.

26. Likewise, there does not seem to be an obvious justification for subjecting bundles which include a price-capped element to a double discount. This may even be detrimental to economic efficiency and the section 18 purpose statement (see below).
27. If different types of services are to be treated differently, it would appear more reasonable to treat them separately before deriving a price for the entire bundle, through a reasonable method of weighting. Alternatively if the two services are to be treated in the same way, then a single discount should suffice.
28. There is another respect in which the IPP does not appear reasonable. Under the current construction of the IPP, the Commission is required to benchmark the discount against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries. It would seem anomalous to derive the discount for a bundle that, for example, largely comprises price-capped residential access and calling service from benchmarking against relevant discounts of non price-capped services in comparable countries. This may also run counter to the section 18 purpose statement for the reasons set out in the section below, 'Impact on the Section 18 Purpose Statement'.

#### **Lack of consistency with other IPPs and FPPs**

29. The approach under the IPP is inconsistent with the IPPs and FPPs for other wholesale designated services in the Act. For other designated services, price-capped and non price-capped services and the discounts that apply to them (i.e. element *b* in the formula) are treated separately at both the initial and final pricing stages.
30. For example, the IPP for "retail services offered by means of Telecom's fixed telecommunications network as part of a bundle of retail services" separates out price-capped and non price-capped services into elements (a) and (b) as follows (emphasis in bold and italics added):

The wholesale price for the retail service is—

(a) in the case of Telecom's **price-capped residential access and calling service** the amount calculated using the following formula:

$$a \times \left( \frac{(100 - b)}{100} \right) = c$$

where—

*a* is the imputed retail price for the service. The imputed retail price must—

- (i) be based on the observed discount of the bundle relative to the total price of the services offered separately; and
- (ii) take into account any price difference that arises from the lower cost of providing the services as a bundle, the lower cost of quantity supply,

any difference in the cost of providing the services between different markets, and from any other difference in cost

*b* is a 2% discount

*c* is the wholesale price

(b) in the case of **any other telecommunications service** offered by Telecom in a bundle of retail services by means of its fixed telecommunications network, the amount calculated using the following formula:

$$a \times \left( \frac{100 - b}{100} \right) = c$$

where—

*a* is the imputed retail price for the service. The imputed retail price must—

- (i) be based on the observed discount of the bundle relative to the total price of the services offered separately; and
- (ii) take into account any price difference that arises from the lower cost of providing the services as a bundle, the lower cost of quantity supply, any difference in the cost of providing the services between different markets, and from any other difference in cost

*b* is the discount (as a percentage) off the imputed retail price for the service. The discount must be benchmarked against discounts applied to comparable retail services in comparable countries that apply retail price minus avoided costs saved or equivalent pricing

*c* is the wholesale price

31. Similarly, where they are offered as individual services, the Act also separates out the treatment of price-capped and non price-capped services into different designated services. Different IPPs and FPPs apply. That is, the IPPs and FPPs differ between:

- “Residential local access and calling service offered by means of Telecom’s fixed telecommunications network,” which is a price-capped service; and
- “Retail services offered by means of Telecom’s fixed telecommunications network”, which covers non price-capped services.

32. Furthermore, in the Final Pricing Principle for “bundles of retail services offered by means of Telecom’s fixed telecommunications network”, the discount term *b*, is separated out between that for non price-capped services and that for price-capped services as follows (emphasis in bold added):

(a) in the case of a **non price-capped service** offered by Telecom in markets in which Telecom faces limited, or is likely to face lessened, competition for that service, avoided costs saved pricing; or

(b) in the case of a **non price-capped service** offered by Telecom in markets in which Telecom does not face limited, or is not likely to face lessened, competition for that service, actual costs saved pricing; or

(c) in the case of Telecom's **price-capped residential access and calling service**, actual costs saved pricing

### **Impact on the Section 18 Purpose Statement**

33. The current IPP results in double discounting. The effects of double discounting and a lack of consistency with other parts of the Act from applying a plain or literal interpretation of the IPP could run counter to the section 18 purpose statement.
34. The imposition of a price cap on a particular service can in some circumstances limit an operator's ability to earn a commercial return from that service. This may occur if the price cap is binding and if the revenue from the service does not cover its costs of provision, including a contribution to common costs. In some cases it may make the service as a whole loss making, or loss making for certain groups of customers. By contrast, the risk of impairing cost recovery is lower for non price-capped services as the access provider does not face the application of a price cap to its services.
35. As a result, compounding the discount applied to price-capped services compared with non price-capped services risks running counter to the Act's purpose of promoting competition in telecommunications markets for the long-term benefit of end-users.<sup>5</sup> This could operate through at least two factors:
  - The incentive for the access provider to invest in the provision of price-capped services may be diminished if there is an impairment to cost recovery. This is likely to impact negatively on dynamic efficiency.
  - Similarly, if an access seeker can purchase price-capped services within a bundle at a greater discount compared with non price-capped services, this may skew its incentives in favour of purchasing bundles that include price-capped services. Similarly if the access seeker can purchase price-capped services at a greater discount when purchased as part of a bundle than when purchased on a stand-alone basis, this may encourage the access seeker to purchase the bundle in order to gain access to the price-capped services at a lower price. In doing this, however, the access seeker would also incur the costs of purchasing other elements of the bundle that it may be able to provide more efficiently itself. This could reduce productive and dynamic efficiency.
36. Lack of consistency with other IPPs: Treating bundles in a manner inconsistent with other designated services in the Act may distort incentives for both the access seeker and the access provider. For example:
  - The access provider may decide not to offer mixed bundles of services because it risks facing a double discount, even where it may be efficient for it to offer such bundles. This could damage allocative and productive efficiency.

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<sup>5</sup> This is likely to be the case unless the application of the current drafting of the IPP closely matches the way in which costs are incurred, i.e. that double discounting is warranted for bundles which include price capped residential and local calling service. The Commission is not aware of such evidence.

- The access seeker may be encouraged to resell mixed bundles as it benefits from a greater discount, rather than purchase the price-capped residential and local access service and bundle this with its own services. Again, this could be sub-optimal and hence be detrimental to allocative and productive efficiency.
37. Treating the different types of services more consistently with their treatment elsewhere in the Act will align incentives to a greater extent.

## ALTERATION PROPOSED IN THE DRAFT REPORT

38. In the Draft Report issued on 1 May 2003, the Commission proposed the alteration to the initial pricing principle for bundles of services described below:

*Initial pricing principle:*

The wholesale price for the bundle is the amount calculated in accordance with the following formula—

$$a \times \left( \frac{(100 - b)}{100} \right) = c$$

where—

*a* is the retail price for the bundle

*b* is the discount (as a percentage) off the retail price for the bundle:

(a) For non price-capped services within a bundle, the discount applied to non price-capped services within a bundle must be benchmarked against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries

(b) If a bundle includes Telecom's price-capped residential access and calling service, the discount applied to Telecom's price-capped residential access and calling service within the bundle is equal to 2% of the standard price

(c) Where a bundle includes non price-capped services and Telecom's price-capped residential access and calling service, the overall discount *b* must be reasonably weighted between (a) and (b)

*c* is the wholesale price

39. The Commission noted in the draft report its view that the IPP ought to be redrafted to make it consistent with the treatment of price-capped and non price-capped services elsewhere in the schedule and to remove the effect of double discounting. The IPP for "retail services offered by means of Telecom's fixed telecommunications network as part of a bundle of retail services" provided a template on which to base an amended IPP as it separates out the treatment of price-capped and non price-capped services.

## SUBMISSIONS ON THE DRAFT REPORT

40. The Commission received submissions on the Draft Report from Telecom and TelstraClear on 30 May, and CallPlus on 13 June. Cross-submissions were made by TelstraClear and Telecom on 19 and 20 June respectively.

### TelstraClear's Submission

41. TelstraClear submitted on what it considers to be four inadequacies of the Commission's proposed amendment. These are:<sup>6</sup>
- (i) The requirement to impute prices;
  - (ii) A perceived increase in the likelihood of the applicant seeking a final pricing review;
  - (iii) A perceived price squeeze for any bundle that included the residential local access and calling service; and
  - (iv) Exacerbating TelstraClear's concerns about the Commission's calculation of the contribution of liable persons under the KSO/TSO.
42. TelstraClear proposes the following amendment to the IPP:<sup>7</sup>
- $$a \times ((100 - b)/100) = c$$
- a is the retail price for the bundle
  - b is the discount (as a percentage) off the retail price for the bundle; a discount benchmarked against discounts applied to comparable bundles in comparable countries
  - c is the wholesale price
43. TelstraClear's proposal does not make a distinction between price-capped and non price-capped services. It proposes that the discount be benchmarked against those applied overseas without making this distinction. Alternatively, TelstraClear proposes the Commission recommend it is not necessary to amend the IPP.
- (i) *The requirement to impute prices*
44. TelstraClear notes that the Commission's proposed alteration to the IPP would require imputation of the prices for the non price-capped and price-capped services within a bundle because different percentage discounts would be applied to each. A final discount for the bundle would be calculated by applying a discount of 2% to the price-capped service, and applying a discount at the benchmarked rate to the imputed price for non price-capped services.
45. However, TelstraClear notes that imputing prices in this context should not be onerous. It would in any event only be required for mixed bundles. Were the

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<sup>6</sup> TelstraClear, Submission on the Commerce Commission's Draft Report on the Initial Pricing Principle for "Bundle of retail services offered by means of Telecom's fixed telecommunications network", 30 May 2003, p. 3.

<sup>7</sup> *ibid.*, p. 4.

Commission to recommend an amended IPP that required the imputation of prices, TelstraClear proposes that:<sup>8</sup>

1. the discount be spread equally across all services, using the formula:  
$$\text{Imputed price} = \text{Individual price} * \text{Price of Bundle} / \text{Aggregate of Individual price of the services in the bundle}$$

or
  2. the Commission assume that the entire discount on the bundled price is derived from the residential access and calling service price.
46. The effect of TelstraClear's proposal 1 would be to assume that the discount to the bundled services is spread equally across price-capped and non price-capped services (see below).
47. The Commission does not consider that point 2 above reflects an appropriate method of imputation. There is no evidence before the Commission to suggest that the reduced price associated with a mixed bundle represents a discount on only the price-capped service.

*(ii) Increase in the likelihood of a final pricing review*

48. TelstraClear submits that the smaller the percentage discount set by the Commission, the greater the incentive of the applicant to seek a pricing review. The Commission has not yet completed a pricing review under any of the FPPs in the Act, and is not, therefore, in a position to judge the relationship of any given IPP with its corresponding FPP, even if such a judgement were appropriate.

*(iii) Price squeeze*

49. TelstraClear considers that the existing 2% discount for residential local access and calling services is flawed, inconsistent with the long-term interests of end-users, and would result in price squeezes if it were applied to price-capped services within a bundle. Telecom would also be encouraged to increase bundling with the residential local access and calling service to reduce competition.<sup>9</sup>
50. CallPlus also submitted that a 2% discount is effectively anti-competitive and would result in price squeezes, and supported TelstraClear's submission that the IPP be amended by removing the 2% discount and applying a discount based on international benchmarking for the entire bundle.<sup>10</sup>
51. TelstraClear further submits that the Commission ought to employ its powers also to investigate the IPP for residential local access and calling service.<sup>11</sup>

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<sup>8</sup> TelstraClear, Submission on the Commerce Commission's Draft Report on the Initial Pricing Principle for "Bundle of retail services offered by means of Telecom's fixed telecommunications network", 30 May 2003, p. 5.

<sup>9</sup> *ibid.*, p. 3.

<sup>10</sup> CallPlus, Submission on the Draft Report on the Initial Pricing Principle, "bundle of services offered by means of Telecom's fixed telecommunications network", 12 June 2003.

<sup>11</sup> TelstraClear, Submission on the Commerce Commission's Draft Report on the Initial Pricing Principle for "Bundle of retail services offered by means of Telecom's fixed telecommunications network", 30 May 2003, p. 6.

52. The Commission is not persuaded that this investigation is the correct process within which to examine the appropriateness of the 2% discount for the residential local access and calling service for a number of reasons.
53. The parties have the option of applying to the Commission to set an FPP for the residential local access and calling service or bundles that include that service:
- within 15 days of receipt of a Determination in which the Commission calculates the IPP; or
  - immediately if adjudication is requested only for price terms.
54. Further, not to apply the 2% discount to the portion of the bundle made up by the residential local access and calling service would raise concerns of competitive neutrality between that service sold alone and sold in a bundle. The Commission considers that the IPP ought to reflect the need for competitive neutrality by not distinguishing between the discount offered for the residential local access and calling service in a bundle and as a stand-alone product.
55. The Commission notes that the Minister's request was specific in requesting an investigation into whether the IPP for bundles of retail services be amended. It did not request an investigation into the IPP for the local access and calling or the parts of bundles designated services.<sup>12</sup>

*(iv) Implications for the calculation of the KSO/TSO*

56. With its IPP submission, TelstraClear resubmitted a paper on the implications of the wholesale regime for the contribution of liable persons under the KSO/TSO.<sup>13</sup> In essence TelstraClear argues that the 2% discount for residential telephony is greatly outweighed by the increased obligation of the reseller under the KSO/TSO due to the revenue of the resold service. Resellers are required to make contributions to the cost of the TSO based on their entire revenues from reselling residential telephony services; therefore, if the liability under the TSO on a resold residential telephony service were greater than 2% it would cost more than the revenue received for a reseller to resell this service.<sup>14</sup>
57. The draft TSO Determination requires that the TSO contributions be calculated on gross retail revenue, which for a resold service falls entirely upon the reseller.
58. TelstraClear submits that the Commission ought to either:
1. allocate the net cost of the KSO on a net revenue basis; and/or
  2. take into account: (i) that retail price may include a contribution to the costs of the KSO; and (ii) that reselling designated retail services will result in liable persons making greater contributions to the net costs of the KSO.

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<sup>12</sup> Letter from Paul Swain, Minister of Communications, to Douglas Webb, Telecommunications Commissioner, 30 January 2003.

<sup>13</sup> TelstraClear, Recovery of the net cost of the KSO and wholesale discounts, 21 March 2003. The paper was initially submitted in the context of the consultations surrounding the calculation of the TSO.

<sup>14</sup> *ibid*, p. 3.

59. The Commission has described its proposed approach to calculating liable revenue in the Draft TSO Determination.<sup>15</sup> All liable persons have had the opportunity to raise concerns they might have with that approach in the context of the Commission's consultation on that Draft. As such, the Commission does not consider that this Report is the appropriate forum to address those concerns.
60. The Commission is also cognisant that the Minister, in his letter to the Telecommunications Commissioner requesting the Commission initiate this investigation, did not refer to the implications of the TSO for the IPP of the designated service specified in that request.<sup>16</sup>
61. Further, the Commission is aware that any implications associated with the calculation of the TSO would reach beyond the scope of this investigation and touch the IPPs and FPPs of all the designated services. The Commission does not consider it would be appropriate to consider these issues within the scope of this investigation.
62. Therefore, the Commission has decided not to consider the implications of the TSO within the narrow context of the IPP of the designated service "bundles of retail service offered by means of Telecom's FTN".

#### **Telecom's Submission**

63. Telecom agrees that the total discount applicable to a type III bundle (a bundle mixing price-capped and non price-capped services) ought to be a weighted combination of discounts determined by considering the price-capped and non price-capped components of that bundle separately.<sup>17</sup> However, Telecom proposes a number of modifications to the amendment proposed by the Commission.
64. Specifically, Telecom offers its preferred formulation of the IPP as:<sup>18</sup>

##### *Initial Pricing Principle:*

The wholesale price for the bundle is the amount calculated in accordance with the following formula –

$$a \times \left( \frac{(100 - b)}{100} \right) = c$$

where—

*a* is the retail price for the bundle

*b* is the discount (as a percentage) off the retail price for the bundle:

<sup>15</sup> Commerce Commission, Draft Determination for TSO Instrument for Local Residential Service for period between 20 December 2001 and 30 June 2002, 27 June 2003.

<sup>16</sup> Letter from Paul Swain, Minister of Communications, to Douglas Webb, Telecommunications Commissioner, of 30 January 2003.

<sup>17</sup> Telecom, Submission on the Draft Report on the Initial Pricing Principle for "Bundle of retail services offered by means of Telecom's fixed telecommunications network", 30 May 2003, p. 1.

<sup>18</sup> *ibid.*, p. 4.



(a) For non price-capped services within a bundle, the discount applied to non price-capped services within a bundle must be benchmarked against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries

(b) If a bundle includes Telecom's price-capped residential access and calling service, the discount applied to Telecom's price-capped residential access and calling service within the bundle is equal to 2% of the standard price

(c) Where a bundle includes non price-capped services and Telecom's price-capped residential access and calling service, the overall discount *b* must be reasonably weighted between (a) and (b) determined by weighting the discount for price-capped and non price-capped services in proportion to the standard retail price for the price-capped and non price-capped service when they are offered outside the bundle.

(d) If a bundle includes non-designated products, the discounts to be applied to non-designated products in the weighting calculation shall be 0%.

*c* is the wholesale price

*(i) Weighting of discount*

65. In submission on the Draft Report, Telecom suggests the following principle should guide the interpretation of "reasonable weighting" in response to the Commission's request for comment on appropriate methods of weighting in order to derive the overall discount to apply to mixed bundles.<sup>19</sup>

The calculation of weights applied to price-capped and non price-capped services within the bundle should be such that the resulting discount on the bundle neither encourages nor discourages Telecom to bundle those services relative to the alternative of selling them in the stand-alone market. The calculated discount on the bundle should be competitively neutral between bundling and unbundling those services – given the manner in which those services would be subject to resale regulation in the stand-alone market.

66. Applying this principle, Telecom suggests that the discount applied to "unregulated" services in the weighting calculation ought to be 0%, should the Commission ever determine resale of a bundle that included such services. To allow a wholesale discount on such services within a bundle, when no such discount would be available to the stand-alone services, would create a disincentive to offer those services in a bundle, when bundling may be economically efficient and in the long-term interests of end-users.
67. Further, Telecom suggests that weights based purely on stand-alone prices will give the upper bound for a discount based on "reasonable weights" as the weights for price capped services based on Telecom's opportunity costs of bundling will likely be higher than weights based on standalone prices. However, Telecom considers that, in the interests of simplicity, weights based on standalone prices would be acceptable for this IPP.<sup>20</sup>
68. As noted above, Telecom recognises that bundles which include services that would not be regulated as stand-alone services (that might not, for example, be offered by means of Telecom's FTN) are within the jurisdiction of the

<sup>19</sup> Telecom, Submission on the Draft Report on the Initial Pricing Principle for "Bundle of retail services offered by means of Telecom's fixed telecommunications network", 30 May 2003, p. 2.

<sup>20</sup> *ibid.*, p. 3.

Commission.<sup>21</sup> An example might be a bundled offering of residential local access and calling, Smartphone services and Sky TV subscription, in circumstances where the latter was not offered in any sense by means of Telecom's FTN.

69. The Commission considers that where a service is not regulated under the Act as an individual service, either under the designated service "retail services offered by means of Telecom's fixed telecommunications network" or the designated service "retail services offered by means of Telecom's fixed telecommunications network as part of a bundle of retail services", an access seeker should not obtain a discount on that service under the designated service "bundle of retail services offered by means of Telecom's fixed telecommunications network". It would be inconsistent with the principle of competitive neutrality for an access seeker to be able to obtain a discount on a service which is not a designated service purely as a result of the service being offered as part of a regulated bundle.
70. Consequently, the Commission agrees with the general approach suggested by Telecom that such services within a bundle of retail services should be discounted at 0%.
71. However, the Commission does not consider the language suggested by Telecom to be appropriate, as the Act does not contain the term "non-designated service". The Commission recommends that the IPP instead state that "[a]ny service within the bundle... that is not a designated service under the Act shall be weighted in proportion to the standard price of the service when it is offered outside the bundle and shall not be discounted".

*(ii) Absolute or Proportional Discount*

72. In its submission, Telecom raises the issue of whether the 2% discount on the price-capped service within a bundle ought to be applied to the standard price of the price-capped service, or the imputed proportional price of the price-capped service within the bundle. The issue only arises for mixed bundles of price-capped and non price-capped services.
73. Telecom submits that the discount of 2% ought to be applied to the imputed proportional price for the price-capped service, rather than to the standard retail price (that is, the absolute price) as proposed in the Draft Report. Once the price of the elements of the bundle has been imputed, a discount could be calculated at 2% for the price-capped service, and the benchmarked rate for the non-price capped services.<sup>22</sup>
74. Telecom accepts that bundling effectively acts as a "bulk discount" off the stand-alone price across product lines, and that the discount ought to be applied to both price-capped and non price-capped products to determine their proportional price within the bundle. In Telecom's view, the Commission's proposed amendment in the Draft Report would create disincentives to bundle where bundling was efficient. As the 2% discount would be applied to the stand alone price of the price-capped service rather than to the imputed

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<sup>21</sup> *ibid.*, p. 4.

<sup>22</sup> *ibid.*, p. 1-2.

proportional price, the total “price” from which the discount was calculated would exceed the price of the bundle.

75. There are a number of methods of imputing the price in order to arrive at a weighted discount for a bundle that includes both price-capped and non price-capped services. These may be expressed using simplified examples. In each case the retail price of the bundle is \$90, but if purchased individually, the price of each stand-alone element is \$50.<sup>23</sup>

**A. Proposal in Draft Report:**

<i>Bundle XY</i> : sold at \$90	Stand alone price	Imputed Price
Residential Local Access and Calling (Price-capped)	\$50	Price not imputed
Smartphone Service (Non price-capped)	\$50	\$30
Tolls (Non price-capped)	\$50	\$30

$$\text{Discount} = (50 \times .02) + (30 \times .16) + (30 \times .16) = \$10.6$$

In example A, the 2% discount is applied to the stand alone price of the price-capped service; but for the non price-capped services, the discount is applied to the imputed price for these services. The imputed prices are derived by calculating the weight of the service in the bundle dependant on its stand-alone price relative to the other stand alone prices for services in the bundle; i.e. one third for each of the two services. In this case, the sum of the prices to which a discount is applied exceeds the price of the bundle. Using a 16% discount for non-price capped services, this gives a total discount of \$10.6.

**B. Telecom’s Proposal:**

<i>Bundle XY</i> : sold at \$90	Stand alone price	Imputed Price
Residential Local Access and Calling (Price-capped)	\$50	\$30
Smartphone Service (Non price-capped)	\$50	\$30
Tolls (Non price-capped)	\$50	\$30

$$\text{Discount} = (30 \times .02) + (30 \times .16) + (30 \times .16) = \$10.2$$

In example B, the 2% discount is applied to the imputed price for the price-capped service. Likewise, the 16% discount is applied to the imputed prices for the non price-capped services in the bundle (calculated using the same method as in example A). This gives a total discount of \$10.2.

76. Alternatively, the weighted discount for the bundle could be calculated without imputing prices for residential local access and calling, but imputing prices for the other elements such that the overall price equals the price of the bundle. If the residential local access and calling service were priced at the standard price, then the remainder of the price for the bundle could be discounted at the rate benchmarked against prices in comparable countries. In this case it is assumed that the sum of imputed prices must come to \$90, but that the prices of the price-capped services within the bundle must equal its stand alone price. This is deduced from the overall price of the bundle; e.g.  $90 - 40 = 50$ . The prices for the non price-capped services are then imputed

<sup>23</sup> In these examples, provided in the interest of clarity, the benchmarked discount applied to the bundle of services is set at 16%. This figure is used merely to demonstrate the relationship of the various alternative approaches, and does not indicate the Commission’s preference, or the likely outcome of an application for determination on bundles of retail services.

depending on their weight within the bundle. This represents the lowest possible wholesale discount for the bundle. Such an approach would produce an overall discount of \$7.4:

**C. Non-imputation of Prices for price-capped services:**

<i>Bundle XY: sold at \$90</i>	Stand alone price	Price for calculation of discount
Residential Local Access and Calling (Price-capped)	\$50	\$50
Smartphone Service (Non price-capped)	\$50	\$20
Tolls (Non price-capped)	\$50	\$20

$$\text{Discount} = (50 \times .02) + (20 \times .16) + (20 \times .16) = \$7.4$$

**CallPlus Submission**

77. On 12 June, the Commission received a submission from CallPlus. CallPlus state that the IPP for bundles contains an error, but question the merit of the Commission's proposed amendment. CallPlus contends that a 2% discount is effectively anti-competitive and would result in price squeezes, and supports TelstraClear's submission that the IPP be amended by removing the 2% discount and applying a discount based on international benchmarking for the entire bundle.<sup>24</sup>
78. While CallPlus acknowledges this may cause a "competitive neutrality" issue, it considers it is not desirable for Telecom to bundle competitive services with monopoly services, which may potentially create a barrier to entry.
79. CallPlus further proposes that the Commission seek to amend the IPP for residential local calling and access to a standard price less a discount based on international benchmarking.

**TelstraClear Cross-submission**

80. On 19 June, TelstraClear filed a cross-submission with the Commission. TelstraClear reiterated its request for the Commission to investigate the IPP for residential local access and calling service and again noted its view that a 2% discount is contrary to the purpose statement set out in section 18 of the Act. TelstraClear also anticipated that Telecom would cross-submit to the effect that TelstraClear's proposed amendment would breach competitive neutrality between the same services offered separately and offered in a bundle.<sup>25</sup>
81. TelstraClear also disputed Telecom's submission that an analogy could be drawn between Telecom's bundles and those of the "fast food" chain, McDonalds.<sup>26</sup> TelstraClear noted several distinctions it perceived between

<sup>24</sup> CallPlus, Submission on the Draft Report on the Initial Pricing Principle for "bundle of retail services offered by means of Telecom's fixed telecommunications network", 13 June 2003.

<sup>25</sup> TelstraClear, Cross-submission on the Initial Pricing Principle for "bundles of retail services offered by means of Telecom's fixed telecommunications network", 19 June 2003.

<sup>26</sup> Telecom offered the following analogy. McDonalds offers "happy meals" (burger, coke and fries) at a discount of around 20% to the stand alone price of these products. Telecom, Submission on the Initial

“happy meals”, a bundle offered by McDonalds, and Telecom’s bundles; namely:

- The products that constitute a happy meal can be purchased separately, while Telecom’s products, such as Jetstream and local access and calling, may not; and
- McDonald’s does not have substantial market power, while Telecom’s bundles tie competitive services with services in which it has substantial market power.

### **Telecom Cross-submission**

82. On 20 June, Telecom filed a cross-submission with the Commission. Telecom replied to TelstraClear’s request that the Commission reconsider the 2% discount, and to the concerns raised by TelstraClear regarding the implications of the TSO calculation for the viability of this discount.
83. Telecom submits that the current process is, at the request of the Minister, directed at correcting a mathematical error in the Act, and that Telecom has not had the opportunity to offer its views on the appropriateness of benchmarking the IPP.<sup>27</sup>

### **INITIAL PRICING PRINCIPLES IN THE ACT**

84. In determining the most appropriate weighting within the bundle for the price-capped service, the Commission has examined the other designated services that require the calculation of a discount for the residential access and calling service.

### **Parts of Bundles Designated Services**

85. The IPP for this designated service was reproduced in full at paragraph 30 of this report. In the case of price-capped services within a bundle, the IPP for that designated service reads:

The wholesale price for the retail service is –

- (a) in the case of Telecom’s price-capped residential access and calling service, the amount calculated using the following formula:

$$a \times \left( \frac{(100 - b)}{100} \right) = c$$

where –

- a is the imputed retail price for the service. The imputed retail price must –
- (i) be based on the observed discount of the bundle relative to the total price of the services offered separately; and
  - (ii) take into account any price difference that arises from the lower cost of providing the services as a bundle, the lower cost of providing the services between different markets, and from any other difference in cost
- b is a 2% discount
- c is the wholesale price

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Pricing Principle for “bundles of retail services offered by means of Telecom’s fixed telecommunications network”, p.2.

<sup>27</sup> Telecom, Cross-submission on the Initial Pricing Principle for “bundles of retail services offered by means of Telecom fixed telecommunications network”, 20 June 2003.

86. The IPP also provides for a similar imputation of price for other telecommunications services in the bundle but requiring discount at a rate benchmarked against comparable countries (i.e. for non price-capped services).
87. As evidenced in the IPP detailed above, where the Commission is required to calculate the value of the residential access and calling service as part of a bundle, the Commission would be required to impute the price for that service based on the stand-alone price of the services that constitute the bundle. This may be demonstrated by means of a simplified example:

**D. Part of Bundle – residential local access and calling service:**

<i>Bundle XY</i> : sold at \$90	Stand alone price	Imputed Price
Observed discount on bundle of 40%...		
Residential Local Access and Calling (Price-capped)	\$50	\$30
Smartphone Service (Non price-capped)	\$50	
Tolls (Non price-capped)	\$50	

Discount on Residential Local Access and Calling Service =  $(30 \times .02) = \$0.6$

88. Not represented in the example above is the effect of paragraph a (ii) of the IPP for the parts of bundles designated service. However, the approach suggested by Telecom for the bundles IPP is consistent with the method adopted by Parliament for calculating the value of the residential access and calling service as part of a bundle of services; that is, this example is consistent with example B depicted above.

**Residential Local Access and Calling Designated Service**

89. There is also an IPP for calculating the residential local access and calling service in the designated service, “residential local access and calling service offered by means of Telecom’s fixed telecommunications network”. The IPP for that designated service reads:
- Telecom’s standard price for its price-capped residential local access and calling service offered to end-users by means of its fixed telecommunications network in the relevant market, minus 2%.
90. Telecom has submitted that its price for “Homeline” is standard, with the only variation being in the Wellington and Christchurch metropolitan areas.<sup>28</sup>
91. The Commission considers that, in determining whether the discount for the price-capped service should be applied to the absolute or proportional price of that service within the bundle, the approach followed in the IPP for parts of bundles ought to take precedence over the approach followed in the IPP for residential access and calling. The Commission considers that the former is the more appropriate comparator as it requires the imputation of prices and concerns the treatment of a price-capped service within a bundle and not as a stand-alone service.

<sup>28</sup> Telecom, Residential Wholesale Application Submission: Appendix 1, 7 March 2003, p. 8

92. This approach is consistent both with the submission of Telecom and the preference of TelstraClear in the event that the Commission chose to recommend an IPP that required the imputation of prices.<sup>29</sup>

## PROPOSED ALTERATION

93. Under clause 4(3)(a) of Part 1 of Schedule 3 of the Act, the Commission must detail the proposed alteration. For the reasons set out in the previous paragraphs, that proposed alteration is the following:

### *Initial Pricing Principle:*

The wholesale price for the bundle is the amount calculated in accordance with the following formula—

$$a \times \left( \frac{100 - b}{100} \right) = c$$

where—

*a* is the retail price for the bundle

*b* is the discount (as a percentage) off the retail price for the bundle calculated in accordance with the following:

- (a) If a bundle includes non price-capped services, the discount applied to non price-capped services within the bundle must be benchmarked against discounts applied to comparable bundles that do not include price-capped residential access and calling service in comparable countries
- (b) If a bundle includes Telecom's price-capped residential access and calling service, the discount applied to Telecom's price-capped residential access and calling service within the bundle is 2%
- (c) Where a bundle includes non price-capped services and Telecom's price-capped residential access and calling service, the overall discount *b* must be determined by weighting the discounts for each price-capped and non-price-capped service (determined in accordance with (a) and (b) above) in proportion to the standard retail price for that service when it is offered outside the bundle
- (d) Any service within the bundles specified in (a), (b) or (c) that is not a designated service under the Act shall be weighted in proportion to the standard price of the service when it is offered outside the bundle and shall not be discounted

*c* is the wholesale price

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<sup>29</sup> As noted in paragraph 45 above, TelstraClear submits that, were the Commission to recommend an IPP that required the imputation of prices for the services within the bundle, the discount should be spread equally across all services in the bundle using the formula:

Imputed price = Individual price \* Price of Bundle/Aggregate of Individual price of the services in the bundle

94. The Commission considers that the above formula:
- Removes the effect of applying a double discount; and
  - Is more consistent with the other formulae in Schedule 1 as it applies a separate discount to individual services depending on whether or not the service in question is price-capped.
95. Applying a separate discount to price-capped and non price-capped services does, however, require the use of a weighting method in order to derive the wholesale price *c* for such mixed bundles. The text in (c) gives the weighted method as proportional to the standard retail price for the services when they are offered outside the bundle.
96. While there are a number of possible methods of weighting, the approach proposed by the Commission is consistent with the approach employed in the IPP for the designated service “retail services offered by means of Telecom’s fixed telecommunications network as part of a bundle of retail services”. It is also consistent with the submissions of Telecom and TelstraClear on the appropriate methods for imputing prices.
97. Paragraph b (d) of the Commission’s proposed amendment can be illustrated by employing the example used above of a bundle of residential local access and calling, Smartphone services and Sky TV.

**Example E: Commission’s Proposed Amendment**

<i>Bundle XY</i> : sold at \$90	Stand alone price	Imputed Price	Discount to be applied
Residential Local Access and Calling (Price-capped)	\$50	\$30	2%
Smartphone Service (Non price-capped)	\$50	\$30	16%
Sky TV (Non price-capped and not designated)	\$50	\$30	0%

$$\text{Discount} = (30 \times .02) + (30 \times .16) + (30 \times .0) = \$5.4$$

**Additional Matters in Schedule 1**

98. In proposing an amendment to Schedule 1, section 19 of the Act requires the Commission to consider, if applicable, the additional matters set out in Schedule 1 regarding the application of section 18. There are not any “additional matters that must be considered regarding the application of section 18” in Schedule 1 for “bundles of retail services offered by means of Telecom’s fixed telecommunications network.”

**COMMISSION’S RECOMMENDATION**

99. Under clause 4(3)(b) of Part 1 of Schedule 3, the Commission must recommend:
- (i) whether or not the proposed alteration should be made; and
  - (ii) in the case of a proposed alteration to a designated service, whether or not the Minister’s decision regarding the proposed alteration should be deferred for any period that the Commission thinks fit
100. The Commission recommends that the proposed alteration described in paragraphs 93 of this report be made.



101. In preparing this final report, the Commission has had regard to all submissions it has received throughout this investigation.
102. The Commission does not consider there is any benefit in the decision regarding the proposed alteration being deferred. On the contrary, the Commission considers that the earliest reasonable implementation of the decision would provide certainty to the industry and assist with a more efficient resolution of the TelstraClear application for determination of “residential wholesale” designated services of 13 November 2002 which is currently before the Commission.

DATED this fourteenth day of August 2003

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke at the end.

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Douglas Webb

Telecommunications Commissioner