13 September 2013

Commerce Commission submission on the Review of the Telecommunications Act 2001 Discussion Document

1. We welcome the opportunity to respond to the discussion document *Review of the Telecommunications Act 2001* (discussion document). Section 157AA of the Telecommunications Act 2001 (Act) provides for the Minister to consult with the Commerce Commission (Commission) in the course of this review.

2. In this submission we concentrate on the network pricing issues identified in the initial phase of the review. We recognise the importance of subsequent phases of the review and that the issues to be considered will be influenced by market developments over the next few years.

3. Our comments focus on the practicalities of the proposals, drawing on our experience as an independent economic regulator and our understanding of regulatory best practice. We focus on the longer-term implications of the proposals for potential future regulation in the telecommunications sector.

4. Our comments also draw on our experience and role in implementing the regulation of copper pricing as required under the Telecommunications Act 2001 consistent with (amongst other things) section 18.

5. However, we recognise that within New Zealand's policy framework it is government's role to undertake any resetting of the pricing principles in legislation, to rebalance prices to end-users, the interests of access providers, and the risks to the transition to fibre.

6. Achieving a market-led transition from copper to fibre, particularly where this is ahead of demand, is not an easy task. As the discussion document points out, this challenge is not unique to New Zealand; it is being addressed in many developed countries.

7. Our submission primarily highlights the need for clarity in the establishment of pricing principles. Clarity in this area is critical in creating a predictable regulatory framework. Regulatory predictability also maximises the prospects for investment and competition for the long-term benefit of end-users (LTBEU) and reduces implementation costs.

The definition of TSLRIC

8. The discussion document concludes *that copper access prices (UCLL and UBA combined) should be roughly equivalent to fibre prices*,[1] and this approach is used as the foundation for setting the combined copper access prices for the three options.[2]

[1] Ministry of Business Innovation, and Employment, *Review of the Telecommunications Act 2001: Discussion Document*, August 2013, p15, paragraph 20.

9. The discussion document acknowledges that the TSLRIC pricing principle and the use of forward-looking costs for network replacement remain sound, and reflect international best practice. However, the discussion document also notes that implementation processes may not be optimal during the transition from copper to fibre.[3]

10. Whichever of the three options is adopted in New Zealand, it follows that the enacting legislation needs to make it clear that the tender-equivalence approach is not a general re-definition of TSLRIC.

11. Absent such a clarification, we consider there is a real potential for regulatory uncertainty to be introduced in the following areas.

    11.1. **How to apply benchmarking if some elements of the supply of the regulated service are competitively procured.** Chorus contracts out for some elements of regulated services. Benchmarking is intended to provide a proxy for modelled long-run forward-looking costs. The adoption of the UFB tender price as a proxy for the forward-looking replacement cost of the copper network raises the question as to whether benchmarking should revert, where possible, to adopting actual procurement costs. This in turn, would raise questions as to the incentives for Chorus to procure efficiently.

    11.2. **How to apply TSLRIC to the other services for which the final pricing principle (FPP) specifies this approach.** TSLRIC unit cost models are typically based on volume assumptions that reflect current demand, modified by expected trends.[4] The bidders for the UFB rollout may have had to factor in that significant capital expenditure had to be incurred well before the uptake in demand (which starts from zero). This ramping up from zero assumption will not usually be appropriate for the TSLRIC for other regulated services, such as interconnection, backhaul and MTAS.[5]

Comment on the options

12. We have reviewed the three options proposed in the discussion document and make the following observations.

    12.1. The process identified for Option One could be complex and potentially time consuming because parties are likely to want to reconcile the price with TSLRIC (or any other objective) and open up a debate about how it is applied in the context of selecting the price within the available range for this option (raising

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[2] Ibid at pp 57-64.
[3] Ibid at para 18
[4] This is explained at page 21 in, Post and Telestyrelsen, *Model Reference Paper (rev B) Guidelines for the LRIC bottom-up and top-down models*, 2007, 07-3652/23, (http://www.pts.se/upload/documents/se/revised_mrp_120907.pdf).
[5] As a related example, Chorus submitted during the UBA process that the TSLRIC for the copper network should reflect a declining demand for copper-based services

issues similar to those discussed above at paragraphs 8 to 11). This could delay the resolution of regulatory uncertainties in the sector.

12.2. Option Two could increase the likelihood of further unbundling amongst access seekers. We considered the relevant incentives in some detail in our recent paper *Unbundled Bitstream Access Price Review – Update on matters relevant to the UBA price review*, currently being consulted on. Relevant extracts from that paper are in Attachment A.

12.3. Options One and Three propose delinking the UCLFS price from the UCLL price. We considered the relationship between the costs of UCLL and UCLFS in our 2012 UCLL determination process, and found it difficult to find a basis on which to ascribe different costs to the two sets of lines.[6]

Future phases of the review

13. In terms of the future phases of the review, we think the issues raised in this area of the discussion document are significant and will require further consideration and investigation before we can provide an adequate response.

14. Finally, while the three options are proposed as temporary (scheduled to end in 2019/20), the migration from copper to fibre networks (which the options are designed to support) will likely continue for some time beyond 2019/20. Forecasts vary widely, but one commentator has estimated that fibre uptake will be around 50% of the eligible premises by the time the LFC contracts end in 2019/20.[7] Therefore, the considerations in paragraph 239 of the discussion document will need to take account of any on-going migration issues.

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[6] Commerce Commission, *Revised draft determination on the benchmarking review for the unbundled copper local loop service*, 4 May 2012, and Commerce Commission, *Final determination on the benchmarking review for the unbundled copper local loop service*, Decision No. NZCC 37, 3 December 2012. (http://www.comcom.govt.nz/regulated-industries/telecommunications/standard-terms-determinations/unbundled-copper-local-loop-service/re-benchmarking-prices-for-chorus-s-unbundled-copper-local-loop-service/)

[7] IDC indicated that fibre uptake will be at approximately 50% (or 600,000 fibre connections) by 2020, cited in *NBR article: It'll be 2020 before half of us have fibre - IDC*.

Attachment A

Extracts from the Commission's update paper on the UBA price review

1. The Commission's recent *Unbundled Bitstream Access Price Review – Update on matters relevant to the UBA price review* (UBA update paper), included a discussion of the likely impacts of increasing the UBA price on future unbundling in New Zealand.[8]

2. Our preliminary analysis indicated that a higher UBA price may:

   2.1 marginally increase unbundling by existing unbundlers; and

   2.2 potentially lead to significant unbundling by Telecom.

3. We noted that any further unbundling may have an impact on the speed of migration to the UFB.[9]

4. The extracts of our analysis in the UBA update paper is contained below.[10]

Extracts from the UBA update Paper

A higher UBA price is unlikely to lead to greater unbundling from existing unbundlers.

94. Unbundling to date has occurred at retail-minus UBA prices that are higher than those indicated in the current benchmark set for a price based on forward-looking costs. In this context it appears unlikely that these unbundlers will be induced to unbundle further exchanges to any great extent by a higher UBA price point which is nonetheless likely to be lower than the current retail-minus price.[11]

95. The submissions from access seekers support this position. We note CallPlus/Kordia's submission that the UBA service is complementary to a voice service and the decision to unbundle will be based on the cost of the two services.[12]

96. The evidence suggests that a UBA price above the median may lead to a marginal increase in competition on the copper network from existing unbundling. Hence any dynamic efficiency benefits which would derive from greater competition are minimal. It is likely, however, to increase the prices faced by end-users.

A higher UBA price may lead to additional unbundling by Telecom

97. The major means by which competition could potentially be promoted by the current UBA price review is if Telecom is induced to unbundle. Once its prohibition on unbundling has expired, Telecom with 49% of the retail broadband market, is likely to have the necessary scale to unbundle both cabinetised and non-cabinetised lines.

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8 Commerce Commission, *Unbundled bitstream access service price review - Update on matters relevant to the UBA price review*, 13 August 2013.

9 Ibid, p 29, para 133.

10 Ibid, pp 22-24, para 94-106.

11 None of the submissions to date have called for a price higher than the current UBA price.

12 See CallPlus/Kordia, *Submission to the Commerce Commission's draft determination on the UBA service price review*, January 2013, p 6. See also UBA Price Review Conference Transcript, Day 2, 13 June 2013, p 185.

98. Hence, the potential impact of the UBA price on competition will depend on how that price affects Telecom's decisions as to the extent, if any, to which it unbundles.[13] The related decisions as to the extent it passes on cost savings to end-users and whether it competes with Chorus by wholesaling bitstream over the UCLL will, in turn, impact upon the LTBEU.

Telecom may already have incentives to unbundle urban exchanges

99. The UBA service geographic averaged prices mean that the price of the UBA service in urban areas is already greater than 'true' cost. This provides an incentive for Telecom to unbundle in urban areas in order to provide broadband services at lower cost.

100. A higher UBA price could increase the cost saving Telecom could achieve by unbundling any given exchange as compared to purchasing the UBA service from Chorus. Thus a higher UBA price may make it more cost efficient for Telecom to unbundle more exchanges should it wish to do so.

101. Therefore, we consider that the major process by which competition on the copper network could be promoted by the current UBA price decision is if Telecom is induced to unbundle a greater number of exchanges.

102. The Commission also notes the submission by CEG[14] that the UBA price may not be 'binding' in urban areas and therefore may not determine the market price. CEG have pointed to the competitive threat of unbundling, in particular from Telecom, as likely to lead to the market price being lower than the UBA price cap.

103. We regard it as more prudent and more logical to assume that the price is 'binding'. It is only in this setting that a higher price point may incentivise some access seekers to undertake additional unbundling where the unbundling costs are close to the UBA service IPP average price.[15]

104. The Commission recognises there is uncertainty here. Despite the cost saving to Telecom (from unbundling rather than obtaining the UBA service from Chorus), Telecom may choose not to unbundle widely or at all if it decides that a rapid migration of end-users to the UFB is its best competitive strategy. This is because unbundling requires a significant upfront investment, which Telecom may consider is better utilised in securing its position over the UFB.[16]

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13 Telecom has noted the impact the UBA price may have on its incentives to unbundle. See UBA Price Review Conference Transcript, Day 2, 13 June 2013, p 240.

14 CEG, *Costing issues in pricing the UBA*, March 2013, pp 13-14, paras 49-51.

15 In carrying out our analysis we are primarily concerned with those areas where the UBA price may be influential in the choice of whether or not to unbundle. In those areas it is unlikely that the threat of unbundling could reduce the UBA price *unless* the UBA price is increased.

16 Telecom, however, would face the cost of the connection fee payable to Chorus for each line unbundled which would be a disincentive to unbundle lines that for which an early migration to the UFB was likely.

The potential benefits to end-users from Telecom unbundling may be muted

105. Two factors may reduce the benefits to end-users of Telecom unbundling.

    105.1 even if Telecom unbundles extensively, it may choose not to compete as aggressively on price as other access seekers or to compete with Chorus (by wholesaling to other access seekers). Therefore end-users may not obtain the full benefit of the reduction in input costs.

    105.2 the benefits for those end-users who would obtain the most value from Telecom providing higher quality services over copper are likely to be temporary because it is likely that these end-users, who put a high value on quality, may soon transfer to the UFB.

Balancing the costs and benefits from a higher UBA price

106. In considering the extent to which the UBA price could promote competition for the LTBEU, the Commission has considered both the costs to end-users from higher retail broadband prices against the likelihood and extent of potential benefits.

    106.1 If a higher UBA price led to Telecom unbundling extensively and this led to lower retail broadband prices and better quality broadband services for end-users then a UBA price above the median would be likely to best promote competition for the LTBEU.

    106.2 If Telecom chose not to unbundle extensively or passed on little cost savings to end-users, then although a UBA price above the median may promote competition in the sense that Chorus's market share in provision of bitstream would be reduced, that promotion of competition may result in marginal LTBEU.

    106.3 End-users who will not be passed by the UFB and whose exchanges were not unbundled by Telecom would incur costs from a higher UBA price as they will face higher retail broadband prices over a prolonged period.[17]

    106.4 The Commission notes CallPlus/Kordia's concerns that an overly high UBA price will incentivise Telecom to sub-loop unbundle, which would disadvantage other access seekers given Telecom is the only operator with the scale to viably sub-loop unbundle.[18] Nevertheless, Telecom unbundling sub-loops could constitute a significant promotion of competition in regard to cabinetised lines. Telecom being the only firm with the market share to make such unbundling viable, is not a valid reason to disregard such an increase in competition. It might imply a concern that competition between Chorus and Telecom in regard to such lines could be less vigorous.

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17 It does not automatically follow that this is inefficient from an economic perspective if the geographically averaged UBA price in those non-UFB areas is lower than the 'true cost' of supply.

18 CallPlus/Kordia, *Submission to the Commerce Commission's draft determination on the UBA service price review*, January 2013, p 4, paras 9-12.