Submission

by

Business NZ

to the

Ministry of Economic Development

On the

Regulatory Implications of Structural Separation Discussion Document

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REGULATORY IMPLICATIONS OF STRUCTURAL SEPARATION
SUBMISSION BY BUSINESSNZ[1]
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1. INTRODUCTION

1.1 BusinessNZ welcomes the opportunity to comment on the Ministry of Economic Development's (MED) *Regulatory Implications of Structural Separation Discussion Document (*referred to as the 'document').

1.2 Since it began as an entity in 2001, BusinessNZ has regularly submitted on various telecommunications issues, primarily advocating a first principles approach when issues are examined. Over this time, there have been various recommendations and decisions made by the Government that have failed to capture key aspects that should be considered. This present document is no exception, and while there are various questions asked in the document, we wish to pick up on some key issues that we feel need to be addressed.

2. SUMMARY OF RECOMMENDATIONS

2.1 BusinessNZ makes the following **<u>main recommendation</u>** with regard to the draft discussion document, namely that:

(a) ***MED look to release a revised discussion document that focuses on the policy principles outlined in the present document, as well as issues relating to such principles that submitters have identified (p.4).***

Notwithstanding our main recommendation above, we also recommend that:

(b) ***A consistent approach is taken to geographic averaging up and down the vertical supply chain. (p.6);***

(c) ***A two-box model, under which Chorus2 is not required to further split into separate business units for layers 1 and 2 proceeds. (p.6);***

(d) ***Revised undertakings that put in place 'Chinese walls' within Chorus2 proceeds (p.7);***

(e) ***After structural separation, the obligation to maintain regulatory accounts for copper services is reassessed to ensure unnecessary costs associated with such obligations are removed. (p.7), and***

(f) ***MED lends itself to technology neutral solutions when examining the structure of future Local Service TSO obligations going forward (p.8).***

[1] Background information on BusinessNZ is attached in the appendix.

3. KEY CONCERNS & COMMENTS

3.1 The Government's ultra-fast broadband (UFB) initiative obviously plays a key role in terms of changing the telecommunications landscape, including how the main players in the market adapt to this change. BusinessNZ agrees with MED that the structural separation of Telecom[2] would represent a major shift in the structure of the telecommunications industry. Such changes will have significant effects for the industry, investors and end-users in New Zealand. Therefore, this is a process that should not be rushed or taken lightly.

3.2 We welcome MED's attempts to produce a discussion document on the structural separation issue. This allows for the implications of any structural separation of Telecom from current regulatory and policy settings to be considered in a transparent manner, as well as for a detailed examination of the policy principles which should inform future decision-making. A well-thought through process with wide consultation and opportunity for input obviously avoids the worst case scenario of decisions made 'behind-closed-doors', which often lead to unintended consequences and misallocation of resources.

3.3 However, despite best intentions, the content of and issues raised in the document are haphazard at best. They reflect the poor policy process that now seems to be a regular feature of an industry that has often, in recent years failed to develop proper principled based understandings of the issues at hand.

3.4 Much of our concern centres on the policy principles that are discussed in section 1.1, which in many respects lead to more questions than answers.

4. POLICY PRINCIPLES

4.1 Section 1.1 of the document outlines seven policy principles that should be taken into account when contemplating any changes in the telecommunications area. The document also asks for views on the principles, including any amendments, deletions, additional principles and relative weighting. These principles are:

- *Promotion of competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand;*
- *Incentivising efficient investment in telecommunications infrastructure and service development by access providers and access seekers;*
- *Allowing consumers to choose between technology platforms on the basis of relative price and performance;*
- *Minimising the compliance costs and competitive distortions of any regulatory intervention;*
- *Ensuring a sustainable industry structure;*
- *Providing sufficient certainty to the industry and ensuring that transitional measures minimise any market or investment disruption; and*

[2] Into 'Chorus2' which would be a new company 'demerged' from Telecom under separate ownership, and 'ServiceTel' which would be the residual Telecom business and a national retail service provider.

- *Only introducing regulation where there is clear evidence of market failure and there are no non-regulatory options which will effectively address the issue.*

4.2 First, we would like to point out that notwithstanding the subjective nature of such lists; we believe the seven principles outlined are a worthwhile basis on which to consider any changes to the telecommunications regulatory regime. In fact, they more or less represent the key elements for any industry where regulatory decisions are required.

Policy principles – past experience

4.3 Looking back, we have to say from past experience that the list provokes a sense of irony when compared with regulatory changes that have taken place over the last few years in the telecommunications industry. It has become very evident to us that significant investigations into areas such as Local Loop Unbundling and Mobile Termination Rates (which BusinessNZ regularly submitted on) were given nowhere near the consideration of the seven principles required. In particular, issues relating to evidence of clear market failure and minimisation of market or investment disruption were not in any way adequately addressed.

4.4 In light of the request by MED to weight/rank the seven principles, a track record of inadequate examination of previous key principles means we would put issues relating to clear market failure and providing sufficient certainly to the industry at the forefront of those principles requiring greater consideration. However, we would temper this view by noting that a simple weighting/ranking of principles applying to every issue in every case can often be a crude measure in itself. In many instances, an evidence based examination of the principles can provide quite a different outlook compared with simply weighting some principles more heavily than others.

Policy principles – context

4.5 Despite the Government's poor track record in adhering to such policy principles, an attempt to consult on the framework of the policy principles is nonetheless welcome. However, where we feel the document essentially unravels is that the sections following on from the short discussion of policy principles involve a preliminary analysis of what/how a structural separation model would look like. Therefore, the proposed structure is obviously outlined <u>before</u> the guiding policy principles have been consulted on, ranked and agreed. While MED correctly point out that the document should not be read as final Government policy, the way the document is structured tends to suggest it is putting the cart before the horse in terms of policy development.

4.6 In addition, while there are elements of the subsequent sections that examine how the revised structure would fit within the various policy principles, much of this appears disjointed. In other areas, the document completely fails to address how MED's views fit with the principles outlined. MED does not attempt to provide an overview of how they see each of the seven principles sitting with the proposed structure, either as a discussion under each of the principles, or even as some form of summary table that goes through the document's main recommendations where the critical areas of change would come under one or more of the policy principles.

4.7 In short, the inclusion of the principles seems more of an afterthought, rather than a genuine attempt to ensure such issues are fully understood and integrated into the process. Rather than delve into the various technical questions asked in the document, we believe it would be more worthwhile for MED to concentrate on fundamental issues raised by the policy principles, outlining in each case how the Government intends to deal with these and where possible identify areas of collaboration/conflict.

4.8 Last, there are many related areas where significant work could be undertaken before the details of the structural separation model are devised, and which would help form the content of an alternative discussion document. These include an examination of some form of codification of the principles into legislation, increased clarity regarding the respective roles of MED, the Commerce Commission and Crown Fibre Holdings, as well as identification of industry pathways for deregulation as well as regulation, with the aim of minimising intervention.

4.9 Therefore, rather than moving forward from the current document, BusinessNZ believes it would be better from a proper policy perspective for MED to release a revised discussion document that focuses instead on the policy principles, including issues relating to such principles that submitters have identified.

Recommendation: That MED look to release a revised discussion document that focuses on the policy principles outlined in the present document, as well as issues relating to such principles that submitters have identified.

4.10 Notwithstanding our views above regarding the present state of the document and the need to step back and examine the policy principles in more detail, there are a few issues in the document on which BusinessNZ wishes to comment.

5. LINE OF BUSINESS RESTRICTIONS

5.1 Paragraph 17 of the document states that *'a key policy objective in the event of a structural separation would be to ensure that the new industry structure is durable and stable'*. BusinessNZ agrees. However, the questions asked in section 3 give an insight into the current mindset of the Government, and in particular the negative approach they appear to adopt. In section 4.8 above, we mention the need for Government to examine deregulation just as much as regulation. However, it appears the mindset seems to fall heavily on regulation to solve potential issues in the industry.

5.2 For instance, question 2 *asks 'what activities should Chorus2 be constrained from participating in, and how would those constraints contribute to end-user benefits?'*. We believe this is the wrong approach to take to ensure a healthy and competitive structure for the future. Instead, the question should be along the lines of '*what activities should Chorus2 participate in, and how would such* *participation contribute to end-user benefits?'*. One could argue that this is simply a case of semantics as both outcomes should lead to the same thing. However, paragraph 19 states that *'the Ministry would also be interested in ensuring that Chorus2 would not be overly constrained and would still be able to innovate and contribute fully in markets where competition concerns do not arise'*. From our perspective, MED appears to be sending mixed messages. Also, asking for feedback on how constraints contribute to end-user benefits covers only one of the seven principles outlined in the document.

5.3 Overall, there appear to be various instances in the document where MED exhibits a muddled and contradictory view of what the future model should look like. Again, while we appreciate the model is in many respects the straw-man for consultation, a more positive approach taking into account all principles outlined would be more advantageous for long-term growth and productivity in the industry.

6. AVERAGED OR DE-AVERAGED COST-BASED PRICES

6.1 Section 4.5 of the document proposes that Chorus2 should be required to provide wholesale broadband (Unbundled Bitstream Access- UBA) services at prices which are geographically averaged, while at the same time maintaining geographically de-averaged prices for its copper loop (Unbundled Copper Local Loop - UCLL) prices.

6.2 From BusinessNZ's point of view, this creates a disconnect between the pricing principles, providing for an unsustainable pricing model that encourages inefficient 'cherry-picking' by retail service providers, as well as accelerating geographically de-averaged retail broadband prices. In short, it seems to lead to the outcome the document claims the Government is trying to avoid.

6.3 The problem Chorus2 will face is that given it will be a structurally separated business that has all of the prices for its services set at cost-based levels, it will not have the capacity to self-fund obligations to geographically average an output price such as UBA when input UCLL prices are also set at cost. As Chorus2's UBA and UCLL prices would be cost-based, Chorus2 would be guaranteed to make losses if averaging was not consistent up and down the vertical supply chains.

Table 1: Example of Cost-Based Pricing

No.		Cost/Price
1	UCLL – Urban Areas	$22
2	UCLL – Non-urban Areas	$39
3	*UCLL – National Average*	*$27*
4	UCLL into UBA Conversion (per line)	$16
5	*Chorus2 UBA National Averaged Price (3 + 4)*	*$43*
6	*Competitor UCLL Price (1 + 4)*	*$38*
7	Difference (5 – 6)	$5

6.4 To illustrate this point, table 1 sets out a hypothetical example of this perverse outcome. Working through the example, UCLL in urban areas is $22 and in non-urban areas is $39. The national average is $27, while the cost of converting UCLL into a UBA is $15 per line (for an entrant). Given these costs, Chorus2 would be able to provide a national-averaged price for UBA of $43, which is the sum of the national average and conversion cost.

6.5 If downstream businesses (including ServiceTel) are permitted to use UCLL in areas that they find profitable and UBA in areas where they would find UCLL unprofitable, they could essentially undercut Chorus2's nationally averaged UBA price in the urban region, thereby cherry-picking for the best outcome. Looking back at the example, downstream businesses would use UCLL in urban areas and offer a price of $38, undercutting Chorus2's UBA by $5.

6.6 BusinessNZ believes that setting up a regulatory regime that leads to such a perverse outcome will relegate Chorus2 to serving only non-urban customers. If Chorus2 is excluded from the urban areas it will be able to serve only its non-urban customers, but at much higher prices, therefore undermining the objective of averaging the UBA service.

6.7 Therefore, in order to avoid such outcomes, it is crucial that the Government takes a consistent approach to geographic averaging so that it is adopted up and down the vertical supply chain.

Recommendation: That a consistent approach is taken to geographic averaging up and down the vertical supply chain.

7. OPERATIONAL AND ACCOUNTING SEPARATION

7.1 We wholeheartedly agree with paragraph 65 in the document that *states 'in considering this issue, an important principle is the need to ensure that regulation is proportionate to the problem being addressed, and that unnecessary costs of regulation are avoided'*. In turn, the document outlines a few areas where improvements can be made.

Two-box model

7.2 Paragraph 72 outlines a two-box model proposal for Chorus2, where Chorus2 is not required to further split into separate business units for layer 1 (unbundled copper loop services) and layer 2 (a variety of bitstream services). This is proposed because the requirement for Chorus2 to maintain separate business units, with detailed rules around governance, is disproportionate in the proposed new structurally separated environment.

7.3 BusinessNZ agrees with this approach, and supports a two-box model without separate business units for either Chorus2 or Telecom2.

Recommendation: That a two-box model, under which Chorus2 is not required to further split into separate business units for layers 1 and 2 proceeds.

Chinese wall model

7.4 As the document points out, it will be important to maintain rules governing the treatment of confidential information within Chrous2. Therefore, revised undertakings will probably require 'Chinese Walls'. These are common commercial practice in other industries, restricting information flows between parts of the business where there is a conflict of interest.

7.5 As the document points out, this type of model is already established in the banking sector, and we see no reason why its use cannot be extended to Chorus2, especially when it would help reduce compliance costs. Therefore, BusinessNZ supports this approach.

Recommendation: That revised undertakings that put in place 'Chinese walls' within Chorus2 proceeds.

Accounting separation

7.6 As paragraph 80 of the document points out, the accounting separation obligations currently implemented by the Commerce Commission apply only to Telecom, requiring Telecom to prepare and disclose information about various activities as if those activities were operated as independent or unrelated companies. The document then asks whether the same obligations should be rolled over to apply to Chorus2 in respect to copper services.

7.7 However, given accounting separation was established to provide relevant information on Telecom's network, wholesale and retail activities, after structural separation there will be two independent and unrelated companies anyway. Therefore, this requirement will be somewhat redundant.

7.8 In short, MED believe accounting separation is a costly remedy, and the obligation to maintain regulatory accounts for copper services should not be reconstituted to apply to Chorus2, and should be removed from Telecom. We agree that changes need to be made that at the very least reassess the unnecessary costs associated with the obligations Telecom undertakes.

Recommendation: That after structural separation, the obligation to maintain regulatory accounts for copper services is reassessed to ensure unnecessary costs associated with such obligations are removed.

8. LOCAL SERVICE TSO

8.1 As section 6.2 of the document outlines, the Government announced a number of reforms to the Telecommunication Service Obligations (TSO), following a review in 2009-10, which BusinessNZ contributed. As the document notes, the structural separation of Telecom has some key implications for the local service TSO, including the structure and assignment of the obligations across differing organisations. It would also potentially complicate TSO's current funding arrangements.

8.2 While the document asks a series of questions, BusinessNZ wishes to pick up on two key points that we believe are critical for the TSO going forward.

Making local service TSO obligations technology agnostic

8.3 Paragraph 100 states that *'in restructuring the TSO obligations to accommodate structural separation, there would be merit in investigating amendments that could be made to ensure that the Local Service TSO obligations are technology agnostic and, in particular, can be delivered over next-generation voice platforms'*. BusinessNZ agrees. One of the common recommendations many submitters (including BusinessNZ) have historically made with regards to fundamental changes to the TSO is that they should be <u>technology 'agnostic' or 'neutral'</u>. That is, the minimum standard of communication technology customers receive should involve a raft of communications technologies and not simply be confined to a landline. The advent of mobile and wireless technologies has meant the potential for choice in communications markets has grown beyond anything the TSO (and in particular the Kiwi Share) was designed for.

8.4 Making the TSO technology neutral would provide numerous possibilities for reform. As an example, an alternative approach to current TSO policy settings would be a simple auctioning off for a set period of time of those customers identified as non-viable to other providers who use alternative forms of technology (thereby turning them into viable customers). This would remove the 'cost' to Telecom as part of the TSO deed, as well as ensuring all customers have a minimum standard of communications technology at hand.

8.5 Beyond some form of first-principles based research that we have long recommended should take place, MED should be conscious of existing research in this space. For instance, the Telecommunications Carriers Forum produced a report in 2008 entitled *'Report on the TSO for local service'*. While there were areas in which there was still disagreement, the report provided a strong basis for a future TSO model that was generally contestable, transparent and technology neutral. The model had <u>close to full support</u> from the major players within the political and legislative landscape at that time.

8.6 Obviously, the report was done against the backdrop of a previous Government, with the new administration making significant policy moves to generate investment in rural areas and to allow competition in delivery of rural services. However, if there are aspects that can be learned from earlier developments and used in new settings, then BusinessNZ would support such moves.

Recommendation: That MED lends itself to technology neutral solutions when examining the structure of future Local Service TSO obligations going forward.

APPENDIX

9. About BusinessNZ

9.1 Encompassing four regional business organisations (Employers' & Manufacturers' Association, Employers Chamber of Commerce Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), its 59 member Major Companies Group comprising New Zealand's largest businesses, and its 76-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is New Zealand's largest business advocacy body. BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

9.2 In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

9.3 BusinessNZ's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.