

Submission

to the

Finance and Expenditure Committee

on the

Telecommunications Amendment Bill

by

InternetNZ

(The Internet Society of New Zealand Inc.)



InternetNZ is the not for profit organisation that manages the .nz domain name space, and seeks to protect and promote the Internet in New Zealand.

August 2006

Public Version (there is no confidential version)

Key Points in this Submission

1. InternetNZ and the Government share the same objectives: to deliver a competitive market in telecommunications that allows for choices among low price, high quality and innovative services.
2. Consideration of these reforms has to bear the importance of nation-building in mind. The market cannot be expected to do the job of government.
3. InternetNZ strongly endorses the package of reforms of which this legislation forms part.
4. Equality of Access should be the governing principle for regulation of Telecom's network.
5. Amend the Standard Access Principles regime and introduce sector-specific competition law and notices.
6. The legislation needs to be amended to provide for a robust operational separation plan for Telecom. InternetNZ proposes a simple amendment to allow for this.
7. A thorough investigation of the costs and benefits of full structural separation of Telecom needs to occur.

InternetNZ

The Internet Society of New Zealand (Inc)

Part One: Submission on the Bill

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Appendix 1: InternetNZ's Stocktake Submission, February 2006

Appendix 2: Figures comparing Telecom's OSP and the BT Model

1. Introduction

- 1.1 This submission is from InternetNZ, the Internet Society of New Zealand (Inc).
- 1.2 InternetNZ is located at Level 9 Exchange Place, 5-7 Willeston St, Wellington (PO Box 11-881, Wellington 6142).

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- 1.3 InternetNZ requests the opportunity to make a presentation to the Committee in support of this submission.
- 1.4 InternetNZ is a membership-based not-for-profit organisation and has the management responsibility for the administration of the .nz domain name registry, a critical component of the Internet infrastructure in New Zealand. Our mission is to protect and promote the Internet in New Zealand; we advocate the ongoing development of an open and uncaptureable Internet, available to all New Zealanders. The Society is non-partisan and is an advocate for Internet and related Telecommunications public policy issues on behalf of the Internet Community in New Zealand – both users and the Industry as a whole.
- 1.5 In developing this submission, InternetNZ has consulted with its members and with other parties, including extensive discussions with ISPANZ (the Internet Service Providers Association of New Zealand (Inc)) and British Telecom.
- 1.6 In this submission, “the Bill” refers to the Telecommunications Amendment Bill. “The Act” refers to the Telecommunications Act 2001 as currently in force. A broader set of technical definitions is available in section 3 of Part 2 of these submissions, dealing with separation issues. General definitions not specified elsewhere are as used in the Cabinet paper setting out the reform package, as released on 3 May 2006.

2. Summary of InternetNZ's Position

- 2.1 The Telecommunications Reform proposals come at a critical juncture in which the Government is committed to an economic transformation agenda. Policy makers everywhere now accept the relationship and the impact of a competitive telecommunications industry with a country's overall economic performance.
- 2.2 The importance of a competitive telecommunications industry was recently highlighted in a 2005 Economic Impact Report (Broadband) commissioned by HiGrowth (NZ) and conducted by the Economist Intelligence Unit.¹
- 2.3 The Telecommunications Reform Package is an admission that the "light handed" telecommunications regulatory regime which has characterised the past 10 years has, *on balance*, not delivered a truly competitive telecommunications market that rewards investment and innovation. Various benchmarks of the New Zealand telecommunications sector and related performance indicators all arrive at the same conclusion.
- 2.4 InternetNZ endorses the overall reform package, the key point being that there is no single measure that will correct the market imbalances that currently characterise the Telecommunications sector. The sector continues to be dominated by the incumbent, which is able to exercise significant market power (SMP) in all areas except for mobile.
- 2.5 And yet, even in the highly "competitive" mobile market, it has been shown that New Zealanders pay excessively high charges and fees for mobile phone services.
- 2.6 Very simply, from an end user perspective, both consumers and business alike, all the evidence points to market failure across the whole sector.
- 2.7 InternetNZ congratulates the Government for its leadership and vision in promoting a very bold agenda for reform of the Telecommunications industry, an essential step if New Zealand is to remain competitive in today's global economy.
- 2.8 If InternetNZ does have a concern with the proposed reform package it is with the overall vision, beginning with the broadband targets that are set out in the policy statement which InternetNZ submits are not bold enough. InternetNZ urges the Government to follow the lead of all our key Asian trading partners (e.g. S. Korea, Taiwan, Japan, Singapore) as well as many EU Countries (e.g. Sweden, Ireland) which are developing Government-led agendas for the establishment of Next Generation Broadband infrastructure. These governments have all quite correctly recognised the critical importance of a 21st century telecommunications infrastructure (e.g. fibre to the home) as a key driver for future economic prosperity.
- 2.9 We submit that the Select Committee should recognise that the drivers for reform of the telecommunications sector need to be placed in a broader context than one of simply creating a more competitive marketplace – the broader context being 21st century nation building.

¹ EIU report reference for HiGrowth

- 2.10 Nation building is the very business of Government – not of the marketplace. Consequently InternetNZ is not convinced that competition alone will deliver the broader nation building objectives that Government is clearly seeking to achieve as a result of the reform process.
- 2.11 InternetNZ therefore urges the Government and the Select Committee to incorporate the notion of nation building more strongly into their final deliberations, beginning with careful consideration of the medium to long term implications of the Telecommunications Reform Package over the next 10 - 15 years; not just the short term wins that can be constructed from reforms such as LLU, UBS and naked DSL.
- 2.12 Please note there is no intention to provide additional comment on issues already covered in InternetNZ's submission to the Telecommunications Stocktake: *"Advancing Telecommunications Services for New Zealand in the 21st Century - Reforming the Regulatory Framework and associated issues"* (Appendix 1). InternetNZ's recommendations in the Stocktake submission have been largely reflected in the Government's telecommunications reform programme.
- 2.13 This submission outlines InternetNZ's position on broadband and other telecommunications issues, the most substantive of which is a discussion about separation options for Telecom.

3. Structure of the Submission

- 3.1 This submission is divided into two parts.
- 3.2 Part One addresses the following:
- 3.2.1 InternetNZ's overall support for the policy objectives that underwrite the proposed legislation, and more specifically, the urgency to establish a truly competitive wholesale broadband market that will close the performance gap from New Zealand's current third quartile OECD ranking to the top quartile of OECD countries.
- 3.2.2 Suggested additional matters for coverage in this legislation which would, if adopted, improve the telecommunications regulatory framework.
- 3.3 Part Two considers specific policy issues concerning the separation of Telecom; separation being an overarching issue which has dominated the industry and media debate following the introduction of the Government's Telecommunications Reform package. InternetNZ will argue that accounting separation, as proposed in the Bill, will not deliver the desired outcomes on its own for closing the "Broadband Divide" in the medium to long term. Nothing short of a robust operational separation of Telecom must be considered if the Telecommunications Reform policy objectives are to be realised, and serious investigation of structural separation is required.

4. Telecommunications Reform: A Policy Decision Matrix

- 4.1 InternetNZ invites the Select Committee to consider the following 7 principles as the basis for a decision matrix on which to evaluate the reach and impact of the individual measures contained in the proposed reforms.
- 4.2 **Consumer focus** – *the interests of consumers, (business and residential), need to be at all times paramount, resulting in decreasing costs and greater choice in terms of services and service providers.*
- 4.3 **Encouraging competition** – *the reforms need to ensure the development of a truly competitive marketplace, which will benefit consumers and provide incentives for new market entrants.*
- 4.4 **Equality of Access** – *at the heart of the reforms should be a commitment to making sure that all players have equal access on fair terms to the incumbent operator's wholesale services.*
- 4.5 **Supporting innovation and enhancing investment** – *the reforms will provide a balanced approach in terms of providing comfort for new entrants considering investment in infrastructure on one hand while at the same time providing investment incentives for incumbents.*
- 4.6 **Creating certainty** – *the reform process needs to ensure regulatory certainty for service providers and investors going forward for at least the next 10 years.*
- 4.7 **Fast and effective** – *the reform process needs to provide for mechanisms and remedies for the industry regulator to resolve disputes, including anti-competitive behaviour, in a timely and expedient manner.*
- 4.8 **Deregulatory** – *the legislation needs to provide for the removal of regulation wherever competition is deemed to be effective.*
- 4.9 InternetNZ has applied these principles in its consideration of the proposed reforms and fully endorses all the measures outlined in the proposed legislation, taking into account the following submissions.

5. Making the reforms work: comment

- 5.1 InternetNZ submits its concerns over the apparent low level of resources at both Ministry of Economic Development (MED) and at the Commerce Commission available for the development of policy advice, and for the effective monitoring of developments in the Telecommunications sector.
- 5.2 InternetNZ is not disputing the use of external advice; this is commonplace and even necessary, particularly in instances where advice from International experts is required.
- 5.3 In the case of MED it is very evident from the background papers the degree to which the Ministry was heavily reliant on external advice to provide the necessary research and related analysis in support of the proposed legislation.
- 5.4 Likewise, the industry has increasingly expressed its concerns in recent times over the apparent lack of resourcing available for the Commerce Commission.
- 5.5 InternetNZ requests that the Select Committee give particular consideration to the level of resources required by Central Government and the regulator to effectively implement and monitor the reform measures contained in the proposed legislation.

6. Substantive amendments to the Bill

Information Reporting regime

- 6.1 Proposed s69D reflects the need to supplement accounting reporting (s69C) with reporting on non-price issues. Non-price discrimination is a particularly strong concern in telecommunications markets.²
- 6.2 However s69D would only require information disclosure after issue of a determination, code or undertaking. The current position under the Act is that, generally, s69D would therefore not apply in practice for a substantial period. For example, a determination generally would not issue until around a year or more after an access seeker first seeks access to a service.
- 6.3 In the meantime there is an hiatus: pricing and financial issues generally would be subject to the s69C accounting separation regime, but non-price discrimination is not monitored or made transparent.
- 6.4 In any event, the application of s69C references back only to the general competition principles (s69A) and not to the standard access principles (SAPs) in Schedule 1 Part 1. As non-price discrimination is a key target of 69C, the SAPs should be specifically identified as matters in respect of which the Commission can require disclosure.

Standard Access Principles

- 6.5 The SAP regime has contributed to market failure and falls short of current best practice in dealing with discrimination. That remains so even with the addition of the SAP requiring disclosure of information ((d) in Schedule 1 Part1),
- 6.6 For example, the SAPs are too generic and set the compliance levels too low. By way of comparison:
 - 6.6.1 Section 152AR(4A) of Australia's Trade Practices Act outlines more detailed SAPs;
 - 6.6.2 Of greater significance, and current best practice, is the substantial change under the BT Undertakings that we outline in detail in Part 2 of these submissions. The Equality of Access regime, comprising in turn Equivalence of Inputs and Equivalence of Outcomes, substantially reduces the prospect of discrimination.
- 6.7 It is submitted that, at least, the SAPs should be amended to incorporate the BT approach.
- 6.8 We note for particular attention the need for a specific SAP (taking the approach in the BT Undertakings) dealing with a common OSS providing the same or equivalent service to wholesale and retail customers (We deal with

² For a recent overview of the problems, see Martin Cave, Lisa Correa and Pietro Crocioni, *Could Non-Price Discrimination justify Functional Separation* (Feb 2006)

OSS at Para {X} below). Commerce Commission Determination 568 (when dealing with OSS for UBS) illustrates that a common electronic OSS may take considerable time to be provided in New Zealand without legislative obligation. New Zealand is well behind other countries in developing such systems, which are also a pivotal part of NGN. We deal with NGN at Para {?} below). Inadequate OSS is often a key source of non-price discrimination (and common OSS is a key solution).

- 6.9 A major problem in the New Zealand Act is that access providers are not required to provide a service, and meet SAPs, until a determination is made. That leads to a delay of a year or more before SAPs are binding on access seekers (the UBS delays illustrate this: it took over 2 years to obtain UBS services from Telecom that came anywhere near the services ultimately determined by the Commission).
- 6.10 Overlapping with the submissions in the next paragraph on competition law, it is submitted that the SAPs should be immediately enforceable (and enforceable by access seekers) before the determination is issued. Compliance can be supported by adoption of an equivalent of the Competition Notice regime, applying this to SAPs. (competition notices are covered in the following Paragraph).
- 6.11 InternetNZ recognises the difficulties in implementing such a regime, but the problem (delayed application of SAPs overlapping with delays in getting to determinations that require access seekers to deliver) is a major problem that is contributing to market failure.
- 6.12 In relation to proposed SAP4 ((d) in Schedule 1 Part 1), the provision should clarify that information is to be provided to access seekers at the same time and in the same detail, as it is provided internally.

Competition provisions and competition notices

- 6.13 The telecommunications market has seen market failure caused by inability to deal with activities by incumbents, such as:
- 6.13.1 Pocket pricing;
 - 6.13.2 Closed network pricing;
 - 6.13.3 Bundling of services at less than the wholesale price;
 - 6.13.4 Bundling or discounting toll services at less than the interconnect rates;
- 6.14 The Telecommunications Act has not been able to solve these problems, nor has the general competition law in the Commerce Act. Even if the Commerce Act applies, there is considerable cost and delay in pursuing a claim.
- 6.15 Australia recognised that general competition law needed to be supplemented by sector-specific law. Hence Part XIB of the Trade Practices Act including the Anti-Competitive Conduct provision (s151AJ). It is submitted that similar provisions should be included in the Telecommunications Act.
- 6.16 The competition notice regime is particularly powerful in Australia, enabling ACCC to give providers notice when it has reason to believe that the carrier is engaging in anti-competitive conduct. If it is later determined that the carrier has engaged in anti-competitive behaviour, that carrier, as well as facing

potential claims by affected providers, can be penalised up to \$10M for each contravention, then \$1M for each day the contravention continues, escalating to \$3M after 21 days. (Section 151BX(1)).

- 6.17 The competition notice regime of course has the effect of encouraging those that receive a notice (or are at risk of receiving a notice) to comply quickly and voluntarily. This is a particular strong and effective mechanism in Australia.
- 6.18 InternetNZ submits that the equivalent of these sector-specific provisions (including competition notices) should be included in the legislation.

Penalties

- 6.19 InternetNZ welcomes the civil infringement and pecuniary penalty regime (proposed Sections 156A-156Q). However, the sums proposed are far too low. The sums payable in relation to competition notices illustrates this. A further example is that penalties in the UK can be up to 10% of turnover in relation to the affected services.

Other matters

- 6.20 InternetNZ expects that others will submit on matters that it will support, and on which it wishes to make oral submission, including in relation to closer definition of the LLU service description, mediation/adjudication, and the standard terms process.

7. Conclusion

- 7.1 InternetNZ endorses the policies that form the basis for the proposed legislation.
- 7.2 InternetNZ urges fast passage of the Telecommunications Amendment Bill.
- 7.3 InternetNZ does not support the accounting separation plan as outlined in the Bill. Accounting separation by itself will not solve the market failure, nor deliver equality of access or adequate assurance of such to the market.
- 7.4 InternetNZ submits that a robust operational separation model, along the lines of the BT model, is absolutely essential. The following part of this submission goes through this issue in detail.
- 7.5 InternetNZ also submits that a detailed study of the options for full structural separation of Telecom be conducted.
- 7.6 The other issues suggested above for amendment taken together improve the Bill without radically departing from the government's policy as outlined in the Stocktake announcements, the relevant Cabinet papers and minutes, and in the explanatory note to the Bill.
- 7.7 Part Two of this submission, on separation issues, begins overleaf.
- 7.8 Thank you for the opportunity to make this submission.

InternetNZ
August 2006

Part Two: Separation issues

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1. Summary

- 1.1 Part Two of this Submission outlines InternetNZ's concerns with the proposed accounting separation model for Telecom foreshadowed in the Bill as well as subsequent announcements from Telecom which outline their intentions to implement a form of operational separation.
- 1.2 Separation of any form should be aimed at changing the incentives on Telecom, so that Telecom is encouraged to act in a manner that promotes competition instead of restricting it. In its current vertically integrated form, all the incentives are to restrict competition, and the regulatory agencies are always in conflict with Telecom's interests.
- 1.3 InternetNZ's view is that a full structural separation of Telecom is the only option in the medium to long term to provide pro-competitive incentives for Telecom. However, InternetNZ recognises the challenges involving structural separation (i.e. could take up to 5 years to implement) so there is likely a need to consider a staged process that delivers more immediate benefits in the short to medium term.
- 1.4 Options for separation were discussed and defined in the Cabinet paper³. The definitions developed in the Cabinet paper, in summary are as follows:
- 1.4.1 **"Virtual" separation⁴ or internal reorganisation:** the maintenance of a separate wholesale division within the integrated incumbent firm. Overseas experiences have proven that this is not workable in terms of delivering true equivalence of supply.
- 1.4.2 **Accounting separation:** a requirement to produce regulatory accounts, designed to verify access pricing by making business unit

³ Cabinet paper paras 69-79.

⁴ This is as set out on page 13 of the Cabinet paper. Others do not apply the same meaning to the term as is given in the Cabinet paper; as such the definition is evolving and InternetNZ does not use it in this submission.

cost components, wholesale prices and relevant internal costs more transparent.

1.4.2 **Operational separation:** a model requiring the maintenance of separate business units for network and wholesale services, distinct from the integrated firm, with separate reporting lines and external oversight by regulatory agencies. This model has been favoured in Australia and the UK.

1.4.3 **Structural separation:** sometimes called ownership separation, this would result in two or more companies whose ownership would respectively be focused on investment in infrastructure (longer term investments with lower returns) and in services under more competitive pressure (providing returns linked to a higher degree of risk).

1.5 This part of the submission first defines the terms used in this jargon-heavy area of public policy. It then outlines the context of the debate about separation and the forms of regulation that are normally applied to industries with a monopoly component. It then proceeds to explain why accounting separation is not on its own appropriate for New Zealand. After outlining what is happening in the UK and Australia with separation, it analyses and critiques Telecom's proposed model of separation for New Zealand. Finally, it explains why InternetNZ supports structural separation and what that could look like in terms of amendments to the current Bill.

2. Definitions

2.1 To assist in understanding InternetNZ's position it is important that the use of terms in this submission is clearly defined at the outset. In this submission the following definitions apply. If definitions are not covered here, then they are as per the Cabinet paper setting out the reforms (released on 3 May 2006).

Accounting Separation	Requirement, to facilitate transparency, to provide accounting information to the regulator, competitors and the public, in relation to aspects of the telco's operations. While the accounts build upon the telco's normal financial accounts, there are enhanced requirements such as details of arms-length transfer pricing between business units etc. The Bill contains a typical accounting separation structure, the details of which would be established by the Commission.
EAB	<i>"Equality of Access Board A board committee established by BT as part of the BT undertakings to oversee compliance with them."</i> ⁵
EAO	<i>"Equality of Access Office An office within BT established by BT as part of the undertakings and with the role of supporting the EAB in its functions."</i> ⁶
Equivalence of Inputs (EOI)	<i>"The concept established processes by the undertakings in which [the access provider] provides, in respect of a particular product or service, the same product or service to all [access seekers] on the same timescales, terms and conditions (including price and service levels) by means of the same systems and processes, and includes the provision to all [access seekers] of the same commercial information about such products, services, systems and processes."</i> ⁷
Equivalence of Outcomes (EEO)	<i>"The concept in which, in respect of a particular product or service, the wholesale input supplied to [the access provider's] own downstream division(s) is equivalent to the comparable product or service supplied to other [access seekers] but not necessarily supplied in an identical manner."</i> ⁸
Functional separation	Another name for operational separation..
IP	Internet Protocol The communications protocol used for transmitting a data packet between a source and a destination on some data networks including the Internet.
KPI	Key Performance Indicator Something which is measured and used as an indicator of performance against a defined target.

⁵ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>

⁶ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>

⁷ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>.

⁸ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>.

LLU	Local Loop Unbundling The mechanism by which Communications Providers other than the incumbent can gain wholesale access to the incumbent's metallic local access network.
NGN	Next Generation Network <i>"A packet-based electronic communications network which is able to provide electronic communications services and to make use of multiple broadband and quality of service-enabled transport technologies, and in which service-related functions are independent of underlying transport-related technologies."</i> ⁹ 21 st Century Network (21CN) is the term that BT uses to describe its NGN
Ofcom	Office of Communications – the telecommunications regulator in the United Kingdom. For more information see their website: www.ofcom.org.uk . The New Zealand equivalent organisation is the Commerce Commission.
Openreach	<i>"The business division created by BT to fulfil the undertakings related to Access Services."</i> ¹⁰ Openreach comprises the network components of BT: <i>"It will be staffed by employees who are presently responsible for the operation and development of BT's local access networks and with senior managers who are incentivised solely on the objectives Openreach rather than the objectives of BT Group plc."</i> ¹¹
Operational Separation	Unlike structural separation, operational separation leaves ownership of the company unchanged. In the leading examples (BT and Telstra) "bright line" edges are put around 2 business units (not just one as suggested by Telecom): a network business unit and a wholesale business unit. The Chinese walls to create this can be relatively low or robust. For example, BT's network business unit (Openreach) is highly robust, but the Wholesale Division has lower "Chinese walls".
OSP	Operational Separation Plan. This is the detailed plan setting out how the operationally separated telco will be structured and function. For BT it is the undertakings given by them to the UK regulator, Ofcom. ¹² For Australia it is the plan agreed, pursuant to the statutory process between Telstra and the Minister.

⁹ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>

¹⁰ BT Undertakings Glossary: <http://www.ofcom.org.uk/telecoms/btundertakings/glossary>

¹¹ http://www.ofcom.org.uk/media/mofaq/telecoms/tsr_faq/

¹² <http://www.ofcom.org.uk/telecoms/btundertakings/btundertakings.pdf>

OSS	<p>Operational Support System <i>"Methods and procedures ... which directly support the daily operation of the telecommunications infrastructure ... including automated systems, supporting order negotiation, order processing, line assignment, line testing and billing".¹³</i></p> <p>Of the 2 components of the Australian OSP that are operationally separated from the rest of the business, one is the OSS business unit (the other is the wholesale division).</p> <p>Ideally, there is a common (largely electronic) OSS platform for both retail and wholesale customers. Telcos internationally are moving to better electronic OSS: if the platform is not common for retail and wholesale, the access provider can more readily discriminate against wholesale customers on a non-price basis.</p>
SMP	<p>Significant Market Power SMP is determined by a market review which is conducted under the relevant provisions of the Communications Act 2003. See: http://www.ofcom.org.uk for more information.</p>
Structural separation	<p>Sometimes called "ownership separation". This involves separating out components of the telco into separate companies, with separate shareholding structures. The companies would be restrained from entering certain lines of business. This can happen voluntarily (for example what was then Fletcher Challenge was split for commercial reasons into 4 separate companies.)</p>
Virtual Separation	<p>An evolving definition which describes a solution at the weaker and less intrusive end of the separation spectrum, ranging from accounting separation to structural separation. It is a structure that requires equivalency of outcomes for retail and for wholesale customers, without the "bright edges" of operational separation.</p>

¹³ Newton's Telecom Dictionary (20th Edition).

3. Regulation in Context: Best Practice and recent events

- 3.1 In network industries that regulators take an interest in, there are usually some forms of monopoly at work. In the case of telecommunications, the generally accepted position is that the local access network – the copper lines to people’s homes and businesses – are effectively a monopoly. This is because in most of New Zealand they are not duplicated by competing infrastructure – there is no widespread second telephone network, and there is no cable television network on a national basis. The owner of the network has an incentive to make prices higher and services less good than in a competitive environment, to maximise returns to their shareholders.¹⁴
- 3.2 To deal with such situations, there are two broad approaches. One is to try and tell the company involved what to do. This is known as “behavioural” regulation. The other approach is to restructure the market and the incumbent company so that there are incentives on everyone to compete, instead of incentives to restrict competition. This is known as “structural” regulation.
- 3.3 Across the OECD, regulators are tiring of the “catch up” nature and inadequate outcomes that arise from “behavioural” regulation. Such a system gives the big players incentives to manipulate the regulatory framework, and leads to slow service improvements and constant reactive responses from Government. Regulators are moving instead to “structural” regulation as a better and more effective way to deliver the universal objective: more competitive markets leading to more innovation, more investment and more competition for the customer dollar.
- 3.4 InternetNZ strongly submits that the current legislation is the right time to move to a “structural” approach to regulation. International experience shows that this will lead to better outcomes.
- 3.5 Under the Bill, Telecom would face accounting separation, a precursor to a “structural” regulatory approach but still mainly in the “behavioural” camp. The company would be required to produce regulatory accounts, designed to allow greater transparency of business unit cost components, wholesale prices and relevant internal costs. [insert cross-references to clauses and other sources, as appropriate throughout]
- 3.6 The aim of such accounts would be to help other carriers get fair, cost based, transparent, and non-discriminating pricing. Accounting separation could also help disclose anti-competitive behaviour such as predatory pricing.
- 3.7 Accounting separation would not change Telecom’s structure. On its own, it is not enough to change the market in an enduring and substantive way. This is why separation as a concept has been a feature of much recent media coverage, and is why Telecom has already gone beyond accounting separation and begun to discuss a form of operational separation as its future operating mode.

Developments since 3 May 2006

- 3.8 The regulatory package announced by Hon David Cunliffe on 3 May 2006 set

¹⁴ Paragraphs 3.1 – 3.4, Cave (2002).

out a much-improved legislative framework for telecommunications regulation in New Zealand. As already mentioned the Society strongly supports the whole breadth of the package.

3.9 Since that time a number of steps have occurred, particularly in terms of the response of the incumbent. Telecom has:

- a) Pledged to cooperate with the new regulatory environment
- b) A new Board Chair has been appointed
- c) Signalled a more cooperative relationship with industry, with the establishment of joint industry working groups to develop the details of the new regulated services and cooperate on other matters, prior to legislation being passed
- d) Made an announcement about proposals to restructure the company, which it is referring to as "separation"
- e) Noted that Xtra (Telecom's ISP) will remain integrated with the company and is not seen as a stand-alone Internet Service Provider

3.10 This context sets the scene for the following sections. First we outline the problems with accounting separation, and then consider the UK and Australian models, discuss the lessons they hold for New Zealand, discuss structural separation and finally make some suggestions for legislative change.

4. Accounting Separation Isn't Enough

- 4.1 Accounting separation has not proved adequate to change the incentives on the incumbent operator to act competitively. It only provides information. The purpose of the government's reforms should be to change the market so that competition is most likely.
- 4.2 Accounting separation can be a useful adjunct to other solutions. It's significantly better to have it than not have it. It arms the regulator, Government and competitors with better information upon which to take action. In the case of New Zealand it could help Telecom demonstrate that it is indeed complying with its obligations and that there is no need to take further regulatory steps.
- 4.3 In Australia and the UK, the relevant regulatory bodies (ACCC and Ofcom) have concluded that the issues and inadequacies around accounting separation mean that more robust measures are required. Accounting separation in itself has not been adequate. In both Australia and the UK the next step up (operational separation) has been implemented. The trend is towards "structural" regulation.
- 4.4 ACCC has been vocal in supporting moving-up from accounting to operational separation. As ACCC's Commissioner Willett has said, the regulatory accounts *"have not succeeded in giving the ACCC a satisfactory handle on the way that Telstra operates its business"* and the accounts provide information that is *"highly aggregated and which could hide specific instances of anti-competitive behaviour."*¹⁵
- 4.5 The Australian Federal Government has taken a similar view.¹⁶
- 4.6 Telecom's Australian subsidiary supports Telstra's operational separation. As AAPT's Head of Regulatory Affairs, David Havyatt, said on behalf of AAPT to the Australian Senate equivalent of a Select Committee:
- "I am more than happy to support the Government's decision to introduce operational separation in the Australian marketplace."*¹⁷
- 4.7 The following two sections of this submission proceed to look at how reorganisation is proceeding in two markets with some similarities to New Zealand – the UK and Australia.

¹⁵ <http://www.accc.gov.au/content/index.phtml/itemId/699320/fromItemId/621277>

¹⁶ See the Explanatory Memorandum to the Australian Federal Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005.

¹⁷ http://www.apf.gov.au/Senate/committee/ecita_ctte/sale_telstra/hearings/index.htm

5. The BT Undertakings (the “BT Model”)

5.1 **Introduction:** Following an extensive review of the telecommunications sector, the UK regulator, Ofcom, accepted, in September 2005, legally binding undertakings from BT to operationally separate. Ofcom had the ability to refer BT to the Competition Commission under the Communications Act 2002 (UK). That body could decide to structurally separate BT. Instead, Ofcom accepted the BT Undertakings involving operational rather than structural separation.

5.2 We overview key strategic points in BT’s operational separation plan (OSP) created by the BT Undertakings.¹⁸ However, the detail in an OSP is important too. As Ofcom has pointed out when making the operational separation decision¹⁹:

“...telecoms regulation is notorious for ‘the devil being in the detail’ and therefore a strategic approach that did not address the detailed implementation issues would have been of limited value.”

5.3 **Policy behind the BT OSP and its key components:**²⁰ This derives from the recognition that there are “*enduring bottlenecks*” where effective and sustainable competition is unlikely in the short or medium term. Enduring bottlenecks are mainly in the access part of the network, where it is economically impossible or inefficient to replicate that part of the network. Thus there needed to be open and truly equivalent access to that part of the network assets that create “*enduring bottlenecks*”. The outcome, at the upstream network level, is that:

5.3.1 this part of BT is operated within a separate and clearly defined division (Openreach); and

5.3.2 the “*enduring bottleneck*” services are to be supplied at wholesale on the same terms as BT makes those services available to itself (this is encapsulated in the key concept: *Equivalence of Inputs* (we expand on this below)).

5.4 Ofcom adopted the principle that regulation should promote competition between competing infrastructures as deeply as is viable. However, such competing infrastructure still relied on open and truly equivalent access to the network assets that created “*enduring bottlenecks*”. Without open and truly equivalent access to “*enduring bottleneck*” sustainable infrastructure based competition would be too risky and too easily frustrated.

5.5 As BT’s Vice President and Chief Counsel notes: “Creation of Openreach is central to [the BT] Undertakings”.²¹

¹⁸ The BT Undertakings are available at

<http://www.ofcom.org.uk/telecoms/btundertakings/btundertakings.pdf>

¹⁹ http://www.ofcom.org.uk/consult/condocs/statement_tsr/statement.pdf

²⁰ The observations in this and the following sub-paragraph derive from Final Statements on its Strategic Review, including paras 1.5 and 4.9:

http://www.ofcom.org.uk/consult/condocs/statement_tsr/

²¹ Gordon Moir presentation in Auckland at the TelCon 7 Conference in Auckland, July 2006.

- 5.6 To supplement upstream access, downstream BT products sold via retail and wholesale channels would be subject also to equality of access measures. Broadly, instead of Equivalence of Inputs controls, there is Equivalence of Outcome ([which is a more transparent and auditable variation on a standard regulatory feature: non-discrimination as between retail and wholesale channels]).
- 5.7 In summary, there is Equality of Access throughout the regime, comprising, broadly, Equivalency of **Inputs** at the upstream bottleneck end of the spectrum, and Equivalency of **Outcomes** at the Wholesale end. This is broken down into a tiered approach, focusing on 4 tiers, which has more robust measures at the upstream levels than at the lower. For example, the “Chinese Walls” are higher for Openreach than for (and within) the other operationally separated unit, BT Wholesale.

BT Operational Separation Plan: overview:

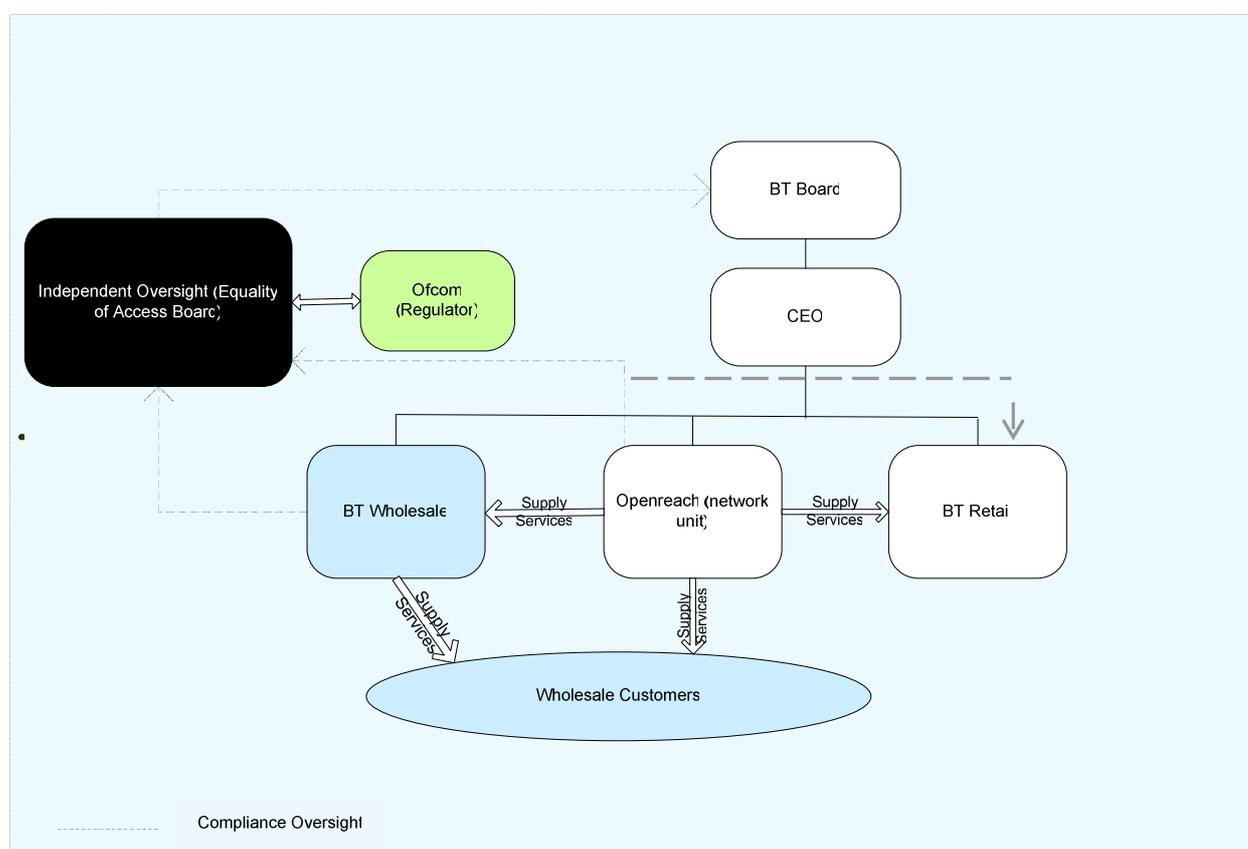


Figure 1: BT Operational Governance structure

Figure 1 overviews key components in the structure:

- 5.7.1 The 2 operationally separated units are Openreach and BT Wholesale (they are divisions of BT not separate companies).
- 5.7.2 **Openreach** provides and sells services on equal terms (Equivalence of Input) to (a) BT Retail, (b) BT Wholesale **and** (c) direct to wholesale customers²². Typically, a Telco with existing infrastructure will take services (or most of them) direct from Openreach (for example, a UK

²² BT Undertakings; Clauses 5.47.1 - 5.47.7

equivalent of a TelstraClear). A provider, such as an ISP without infrastructure, will typically buy its services from BT Wholesale, which in turn has been supplied upstream services by Openreach.

5.7.3 There are 11 services that Openreach provides which are bottleneck services and subject to Equivalence of Inputs obligations.²³

5.7.4 Openreach also sells other products where Ofcom has determined that BT has Significant Market Power (SMP). For these products, the Equivalence of Outcomes test applies instead.²⁴

5.7.5 Openreach services include PSTN calls and access, digital voice service access, LLU, Ethernet circuits from customer (to both the first exchange and from that exchange to another exchange) (inclusion of Ethernet is a major development) and co-location of equipment at exchanges.

Note: This contrasts with Telecom's proposed inclusion at this level of only "*regulated broadband access products*" which is a much narrower set of products, as discussed further in section 7.

5.7.6 **BT Wholesale** sells 2 categories of services which are subject to OSP obligations²⁵ (leaving aside certain products that are not controlled):

5.7.6.1 All regulated (SMP) wholesale products other than those supplied by Openreach (Equivalence of Outcomes applies). The unit within BT Wholesale called BTWS supplies these products;

5.7.6.2 Non-regulated wholesale products of significance to wholesale customers (lower standards than *Equivalence of Outcomes* apply). The unit within BT Wholesale dealing with these products is BTS.

5.8 There are obligations on each of these tiers (the 2 Openreach streams and the 2 BT Wholesale streams) such as Chinese walls, information flows, etc. The level of robustness of these obligations broadly dilutes as the services move from upstream (Openreach) to downstream (BT Wholesale and BT Retail), to meet requirements for a flexible and workable solution.

5.9 BT's regulatory accounting obligations remain in place, adjusted to accommodate the requirements of the OSP.²⁶

²³ Wholesale Analogue Line Rental; Wholesale ISDN2 Line Rental; Wholesale ISDN30 Line Rental; Wholesale Extension Service; Shared Metallic Path Facility; Metallic Path Facility; IPStream; Backhaul Extension Service; Wholesale Extension Service Access Product; Wholesale Extension Service Backhaul Product; Wholesale End-to-End Ethernet Service (plus successors to the IPStream, Datastream and Wholesale Line Rental services).(BT Undertakings; clause 3.1)

²⁴ These products are outlined at clauses 5.3 and 5.4 of the BT Undertakings

²⁵ BT Undertakings; clauses 6.1-6.5

²⁶ BT Undertakings; Clause 5.30-5.32

- 5.10 The BT undertakings establish an Equality of Access Board, which monitors and reports on compliance with the Undertakings. It covers the whole BT operation to check for OSP compliance, but focuses in particular on the Equivalence of Inputs obligations²⁷. That Board in turn is resourced with an office to help it undertake its functions.
- 5.11 *“All incentive remuneration of BT employees working for [Openreach] shall reflect solely the objectives of Openreach.”*²⁸ The position is the same for BTWS staff in BT Wholesale²⁹.
- 5.12 The Openreach CEO reports direct to the BT CEO, and he or she does not participate in BT senior management discussions unless Openreach matters are being discussed (and when this happens it must be reported to the Equality of Access Board).
- 5.13 Staff generally work exclusively for BT Wholesale, Openreach or the rest of BT, although all can use some general functions (e.g. BT lawyers can work on Openreach matters).
- 5.14 The model seeks to strike a pragmatic and workable balance, by incorporating existing BT structures (e.g. BT Wholesale).
- 5.15 **Equivalence of Inputs:** This principle is central to the BT model. It requires absolutely the same treatment by Openreach of *all* service and product provision – whether to BT Wholesale, BT Retail, or to any other wholesale customers. Equivalence of Inputs means:
- “**Equivalence of Inputs**” means the provision of the same products and services by BT to all Communications Providers (including BT) on the **same** timescales, terms and conditions (including price) by means of the **same** systems and processes, and includes the provision to all Communications Providers (including BT) of the **same** Commercial information about such products, services, systems and processes. In particular, it includes the use by BT of such systems and processes in the **same** way as other Communications Providers and with the same degree of reliability and performance as experienced by other Communications Providers.”* (Emphasis added)³⁰
- 5.16 This principle is the absolute key to the move away from traditional regulatory solutions with a focus on outputs (through equivalence of outcomes/non-discrimination), toward a focus on inputs (solutions based on better regulation of the network’s “enduring bottleneck” components). Or in other words, it is integral to the growing move away from “behavioural” regulation towards “structural” regulation, as discussed in section 3 above.
- 5.17 There is an increasing recognition by regulators and others that “*bright-edged*” and clearly delineated operations are required to achieve effective equivalence of input. It is too hard to achieve this without “*bright-edged*” structures. Having an equivalence of input regime for supply into a wholesale

²⁷ BT Undertakings; Clause 10.9

²⁸ BT Undertakings; Clause 5.36

²⁹ BT Undertakings Clause 6.6

³⁰ BT Undertakings; clause 2 (EoI is subject to minor case-specific variations outlined in clause 2

division such as BT Wholesale won't work unless the supplier also has clear and "bright-edged" boundaries. Thus the Openreach "bright-edged" division is a key component: without it, the solution will not work. Australia has recognised this too, with their OSP containing 2 "bright-edged" separated divisions. Wholesale and, as a variation on the Openreach solution, an OSS division, which is the channel through which upstream services are supplied to wholesale and retail on an equivalent basis. Note that it is bright-edged, at the very least, by virtue of its structure.

- 5.18 **Operational Support Systems (OSS):** Pivotal to equivalence of inputs is equivalence in the way wholesale customers get their services. It is pivotal because it is in OSS that non-price discrimination on the part of incumbent providers is most easily imposed on wholesale customers. OSS and related services have been the subject of substantial discrimination by telcos against other carriers including downstream wholesale customers.³¹
- 5.19 This is done via billing, supply and provisioning platforms generally known as OSS. Telecommunications carriers have a multitude of complex legacy OSS platforms; the promise of next generation networks (NGN) is a single common electronic platform, available for supply to retail as well as wholesale customers. Telcos internationally, including Telecom, BT and Telstra, are upgrading their networks to NGN (called 21CN by BT). This presents an opportunity to migrate to non-discriminating electronic OSS instead of (a) legacy and outmoded OSS and (b) OSS which discriminates against competitors and downstream wholesale customers.

Benefits of the OSP for BT

- 5.20 As well as avoiding structural separation through the Undertakings it has agreed with Ofcom, BT has gained the following:
- 5.20.1 A more certain regulatory environment from which to invest in NGN, in cooperation with other providers;
- 5.20.2 As a *quid pro quo*, Ofcom is steadily removing retail regulatory restraints;³² because the OSP reduces the need for them;
- 5.20.3 A more positive relationship with the wholesale sector (rather than the historical "games"), and additional channels to market (wholesale). It is apparent that BT has embraced the OSP very positively³³. So has the market, with BT shares going up around 10% when the BT Undertakings were announced.

³¹ For an exposition of the issues, see Martin Cave, Lisa Correa and Pietro Crocioni; *Could non-price discrimination justify Functional Separation* (February 2006). For a New Zealand example of the issues and complexities, see the Commerce Commission's TelstraClear-Telecom UBS Determination No 568 (December 2005).

³² See http://www.ofcom.org.uk/media/news/2005/12/nr_20051215_2#content and <http://www.ofcom.org.uk/consult/condocs/retail/statement/rpcstatement.pdf> for examples of this.

³³ This was apparent for example from the genuine enthusiasm reflected by BT's Vice President and Chief Counsel in his presentation at the TelCon.7 conference in Auckland in July 2006.

Next Generation Networks (NGN):

- 5.21 A key feature of the Undertakings is that they include a range of commitments about the rollout of NGN services across the UK by 2010³⁴, and the access to these services that will be available to wholesale competitors of BT.
- 5.22 *“Ofcom’s new approach would require BT to roll out its NGN so as not to cut off access to other operators and to provide access to those operators on an equal basis (in regulatory parlance, “equivalence of inputs”) to that of the rest of BT. Importantly, no new retail products using the NGN could be launched without equivalent wholesale products being available.”*³⁵
- 5.23 By protecting the “equivalence of inputs” principle and applying it to future network technologies, Ofcom has ensured that competition will be a feature of the telecommunications market for the foreseeable future. *“The regulatory framework is adapting to the new reality – Equality of Access for enduring bottlenecks is key.”*³⁶ (Referring to NGN’s.)
- 5.24 *“Another crucial issue is the regulation of future technologies. Here, again, Ofcom has seen fit to depart from the 2003 framework -- which focuses on regulating today -- to arrive at a set of rules which regulate the future. This is an important intellectual and emotional jump both for Ofcom and BT: by establishing a framework which will govern BT’s implementation of 21 CN and, where BT has market power, the products delivered over it, Ofcom hopes to establish an environment which will allow competitors to flourish in a way which has not hitherto been possible.”*³⁷

³⁴ BT Undertakings, clauses 11.1 – 11.20.

³⁵ Olswang *Telecommunications Update: Telecoms Strategic Review*, November 2005, online at <http://www.olswang.com/news.asp?page=newssing&sid=114&aid=1247>

³⁶ Gordon Moir, BT Chief Counsel and Vice President, presentation to TelCon7 Conference, Auckland, July 2006.

³⁷ Towerhouse Consulting – “The regulation of telecommunications networks and services in the UK” – August 2005. Accessible as ‘MTS Allstream-Appendix D-Towerhouse.doc’ on <http://telecomreview.ca/epic/internet/intprp-gecrt.nsf/en/rx00043e.html>

6. The Australian Operational Separation Model

- 6.1 Australia has chosen to implement a form of operational separation for its incumbent provider, Telstra Australia. This decision was implemented after accounting separation proved inadequate to deliver a more competitive market (see the quote above, section 4.4 on p. 22).
- 6.2 The model is based on operationally separating two business units from the rest of the Company. These business units are a network (particularly OSS) division and a wholesale division.
- 6.3 The model is fundamentally different to the BT model described above. Robust equivalence of Inputs is not a governing principle, and there is no fully separated network division along the lines of the Openreach structure outlined above.
- 6.4 Given Telstra's status (51% owned by the Australian government) and the significant differences between their OSP and that applying to British Telecom (arguably a result of the government's ownership interest conflicting with its role as regulator), the outcome in Australia is substantially weaker than that advocated by their regulator.
- 6.5 New Zealand shares the British situation of a long-privatised network incumbent and a general adherence to competition law principles in regulating telecommunications. For this reason and because of the ownership issues just mentioned, the British model is of more relevance to New Zealand, and forms the substantive basis of comparison in what follows.

7. Telecom's Operational Separation Plan (OSP)

- 7.1 On 11 August Telecom detailed its intentions for operational separation, part of the commitment to change announced by the company on 12 May following the government's policy announcements on 3 May.
- 7.2 The company is developing plans to undertake operational separation by requiring its wholesale division to operate with the following key undertakings in place:
- 7.2.1 Acceptance of a principle about 'Equivalence of Inputs' for regulated broadband access products, and 'Equivalence of Outcomes' for all other wholesale products.
 - 7.2.2 The establishment of an Independent Oversight Group to monitor Telecom's compliance with the Equivalence of Inputs principle.
 - 7.2.3 Ensuring wholesale short-term performance incentives have no Telecom Group component.
 - 7.2.4 The roles and responsibilities of the wholesale group to be closely defined and monitored.
- 7.3 A cursory examination of the BT model, Telstra's model and Telecom's proposed plan for operational separation reveals significant differences with respect to how operational separation is being implemented. Getting the most appropriate model in place for New Zealand is critical to securing the Government's desired outcomes.
- 7.4 Clearly the Government already has a view, as confirmed in various statements by Ministers, that the benchmark for the separation debate is the "BT model" (outlined in section 5 above) and further, that the BT model is seen as an appropriate and preferred one to apply in New Zealand.
- 7.5 *"I've been quite clear that I believe that a more positive and proactive attitude towards competition, such as that taken by British Telecom when it voluntarily separated its company, would have been good for Kiwi shareholders."*³⁸ – Rt Hon Helen Clark, reported in the *NZ Herald*, 13 June 2006.
- 7.6 *"Those announcements also indicated a commitment to proceed at least as far as accounting separation for Telecom. However, it is expected that the Select Committee looking at the proposed legislation will also consider the merits of proceeding further on such matters as other forms of structural separation."*³⁹ – Hon Dr Michael Cullen, Budget Speech, 18 May 2006.
- 7.7 *"There is at least a very arguable case that the BT approach has been value-maximising in similar circumstances in the UK," New Zealand Communications Minister David Cunliffe said last month. "The advantage of doing it voluntarily is, of course, they are then more in charge of the terms*

³⁸ http://subs.nzherald.co.nz/section/story.cfm?c_id=5&ObjectID=10386307

³⁹ <http://www.treasury.govt.nz/budget2006/speech/01.asp>

upon which it is done.”⁴⁰ – Hon David Cunliffe, reported in *Australian IT*, 13 June 2006.

- 7.8 Hon David Cunliffe also noted, at the initial announcement of this direction from Telecom (June 2006), that *“An initial scan of the announcement indicates that there may be significant differences between Telecom’s proposals and, for example, the BT Openreach model.”*⁴¹
- 7.9 Notwithstanding the Government’s clearly expressed preferences, a comparison of the “BT model” and Telecom’s proposed plan shows significant differences; notably:
- 7.8.1 Telecom’s plan does not have a separate Network Group (like BT’s Openreach), the key innovation in the BT model. It only operationally separates the Wholesale Group (BT have separated both Wholesale and the Network Groups);
- 7.8.2 Because it does not include a separate Network Group, Telecom’s plan cannot deliver true Equality of Access. This is because the lack of such a Group means Equivalence of Inputs cannot be realised⁴², and Equivalence of Outcomes becomes difficult if not impossible to achieve.
- 7.8.3 The Telecom plan uses Equivalence of Inputs on only “regulated broadband access products”. Openreach, by contrast, supplies 11 EoI products only some of which are the “regulated broadband access products” to which Telecom refers.
- 7.8.4 Telecom do not acknowledge that BT Wholesale and Openreach are both obliged to provide Equivalence of Outcomes products, and portrays its own offer to provide these as an improvement over the BT model.
- 7.8.5 Implicit is that Telecom wholesale staff are incentivised based on Telecom group performance in the long run. This is in direct contradiction to Openreach (and BT Wholesale’s relevant unit BTWS) requirements that performance-based remuneration be solely related to those Groups’ own performance, and means that the strong incentives for behaviour consistent with Equality of Access that are present in the BT model, are not present in Telecom’s plan.
- 7.10 Telecom made direct comparisons with the BT model, but did note that there are some differences. Mark Ratcliffe, Chief Operating Officer Technology & Enterprise (effectively manager of Telecom’s network and responsible for the proposed OSP), said at the 11 August briefing:

“We also believe in the interests of being transparent that we should point out

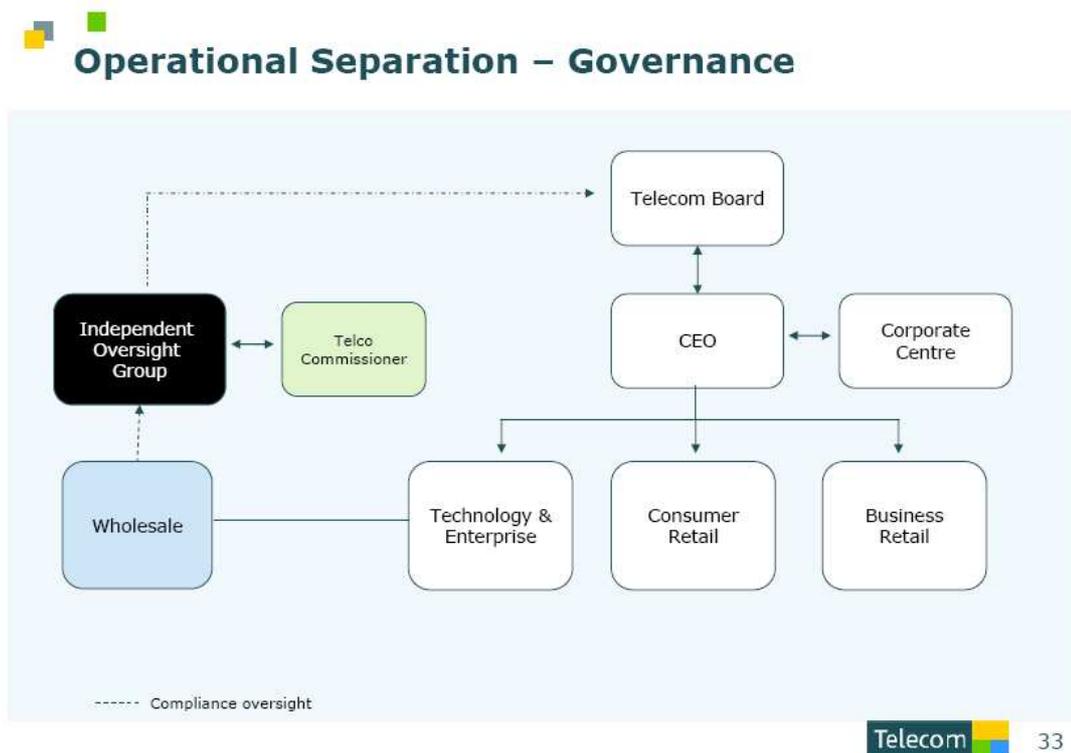
⁴⁰ http://australianit.news.com.au/articles/0,7204,19450437%5E16123%5E%5Enbv%5E_00.html

⁴¹ http://www.nbr.co.nz/home/column_article.asp?id=15544&cid=4&cname=Busine

⁴² This is because the lack of such a Group, under strict obligations to adhere to these principles and monitored in its implementation of them, leaves the network owner with every reason to deny fair and equal access to its competitors – with limited prospect of discovery in so doing.

that there are differences to what we are proposing in terms of a model and the one that British Telecom there. **We believe these are relatively minor characteristics that don't impact on any of the outcomes that we are looking to get or that our stakeholders are looking to get from the models we are proposing**⁴³ (emphasis added).

- 7.11 InternetNZ does not agree that the differences are minor. They are very significant. The lack of an 'Openreach' equivalent in Telecom's OSP makes any comparison with the BT model tenuous at best.
- 7.12 Telecom's diagram of its proposed OSP governance structure is below, for your reference:



⁴³ <http://www.telecom.co.nz/content/0,8748,200681-1563,00.html>

8. Discussion

- 8.1 InternetNZ's position is that the BT model is the most appropriate one for New Zealand to adopt.
- 8.2 InternetNZ submits that this position is clearly shared by the Government, as demonstrated by the quotes cited in section 7 above.
- 8.3 If Government is committed to implementing a variation of the BT model in New Zealand, the significant differences between that model and Telecom's plan need to be clearly understood. These differences are shown in the four figures included as Appendix 2. The figures include InternetNZ's comments, and show the following:
- 8.3.1 Telecom's governance structure as proposed in its OSP (Figure 2).
 - 8.3.2 The BT model's governance structure (Figure 3).
 - 8.3.3 A chart showing Telecom's asserted similarities with the BT model (Figure 4).
 - 8.3.4 A chart showing aspects of the BT model that Telecom asserts are not relevant in New Zealand (Figure 5).
- 8.4 New Zealand's light-handed approach has, as noted at the beginning of these submissions, been unusual when compared with comparable jurisdictions. The modest re-regulation delivered by the 2001 Act has delivered significant gains already; future steps towards a more internationally-comparable regulatory framework can be expected to do the same. The costs have been clearly outweighed by the benefits already gained to date.
- 8.5 While a mandated operational separation would cost money, it should be noted that telecommunications companies are constantly reinventing themselves and undergoing restructuring, especially in light of the development of Next Generation Networks. Telecom has stated at its analyst briefings on 11 August that it is at the opening stages of a major restructuring, to implement its new business model. Any costs arising from operational separation would be incidental to the ordinary restructuring costs Telecom would face regardless. One of Telecom's objectives in proposing its own operational separation plan is to *"use the proposed Operational Separation model to support and drive transformational change within Telecom"*⁴⁴.
- 8.6 Operational separation inevitably carries cost and disruption. Incumbents maintain that this is additional cost and complexity for little or no benefit, with adverse impacts on that key ingredient in the telco world: incentive to invest.
- 8.7 ACCC and Ofcom are typical of a regulatory ground-swell in favour of this solution, in view of the failure of other regulatory settings to solve market failure.

⁴⁴ Ref Telecom briefing p30, 11Aug

- 8.8 While New Zealand can learn a lot from the developments in the UK and Australia, just how effective OSPs will be is not yet certain in this complex area. However, those two countries have so strongly recognised the need to go down this path (and the failure of other solutions) that it is essential for this path to be taken in New Zealand. If we fail to take steps and get this one wrong, there will be another several years' delay if provision is not made in this legislation.
- 8.9 Adoption of the concept and implementation of operational separation (and rejection of other models) is so far advanced elsewhere that the question should be: *"What reasons are there **not** to introduce robust operational separation straightaway?"* rather than the other way around. Telecom's Australian subsidiary supports robust operational separation and it is hard to see why Telecom would take a contrary line here.
- 8.10 In fact there is more reason to have operational separation here than in Australia or the UK. New Zealand's problems are more serious than in either country:
- 8.10.1 Due to the small market size and difficult terrain, there is less likelihood of alternative mass infrastructure (e.g. ubiquitous HFC cable) being developed than in Australia or the UK.
- 8.10.2 As a consequence, the New Zealand market is more heavily dominated by the incumbent provider. For example, BT has only 26.3% of the UK retail broadband market, which is substantially less than Telecom's share of approximately 80%. Situations of significant market power are more extensive than is the case in either country.
- 8.10.3 Therefore to create Equality of Access and deliver a more competitive market for telecommunications, a highly robust solution is required that can effectively restrain an incumbent more powerful than in either country.
- 8.11 It is to be expected that Telecom will argue (in stark opposition to the approach it took in Australia in relation to Telstra) that the OSP should be relatively weak, rather than the robust model that AAPT clearly sought in Australia. They will also seek to argue that New Zealand's circumstances are unique. Already the model Telecom proposes is misconceived and well short of the benchmark they adopt: the BT model. It can be expected that they will argue that a robust OSP will be unduly disruptive and costly.
- 8.12 This needs to be put into context. According to Telecom's financial results for the year ending 30 June 2006, announced on 11 August 2006⁴⁵, its New Zealand operations had operating revenue of \$4.5 billion and earnings before interest, tax, depreciation and amortisation (EBITDA) of \$1.7 billion (that is, around \$20 per Kiwi). The turnover of the telecommunications industry in New Zealand exceeds Telecom's turnover by a significant amount.
- 8.13 Of much greater significance is the impact of Telecom's operations and the telecommunication sector generally, including broadband, on the New Zealand economy as a whole, as is illustrated by the Hi-Growth Trust Report referred to in Part One of this submission.

⁴⁵ <http://www.telecom.co.nz/content/0,8748,200681-1563,00.html>

- 8.14 In that context, even if the cost involved in implementing a robust OSP (to address market failure issues already recognised in other countries) was high, it would remain entirely justifiable due to the benefits that would be realised.
- 8.15 However Telecom is predicting that the costs are not that substantial. In his review on 11 August 2006 at the Telecom briefing at the announcement of its annual results⁴⁶, Telecom's CFO, Marko Bogoevski noted:
- "And there are other things like direct costs of complying with the regulatory regime. You know, I wouldn't underestimate the ... costs of funding legal teams and reviews and things like operational separation preparation. They're exceeding \$10M of incremental costs next year. We think that is our estimate currently of direct compliance costs simply to prepare for the new regulatory environment and participate in things like the submission process and consult with the industry."*⁴⁷
- 8.16 All this was being said on the assumption that Telecom would be rolling out an OSP which it was comparing with the BT model, as is clear from that presentation.⁴⁸
- 8.17 In any event, the Commission (or the Minister, as appropriate) can determine, as happened in Australia and the UK, that the OSP should fit with Telecom's existing business model. Adoption of something like Clause 48(2)(g) of the Australian Act will go a long way to help minimise negative and excessive impact on Telecom.
- 8.18 Gordon Moir, Chief Counsel and Vice President at BT, commented⁴⁹ that the cost and difficulty of implementing the BT OSP was similar to the sorts of restructure that telcos all go through from time to time. In other words this was well within the expectations of any normally functioning telecommunications company.
- 8.19 There has been a recurring theme coming from Telecom, repeated many times by senior management. *"Now we have been listening and we will continue to listen to Kiwis - our shareholders, our customers, industry groups, officials and the Government."*⁵⁰ *"You've heard us consistently say over the last three months that we are getting on with it. We've made some changes which you have heard about, some which have heard us talk about, some which you may have seen. We are actively listening to what our many stakeholders say..."*⁵¹ *"We get it"*⁵²
- 8.20 Telecom rightly recognises that this change of tack will be met with scepticism, even if it is genuinely motivated. It flies in the face of numerous actions to the contrary over the years. It flies in the face of the universal approach by incumbents. Arguably, to come up first with positive strategies

⁴⁶ <http://www.telecom.co.nz/content/0,8748,200681-1563,00.html>

⁴⁷ From his presentation at the TelCon.7 conference in Auckland in July 2006.

⁴⁸ See for example the slides at <http://www.telecom.co.nz/content/0,8748,200681-1563,00.html>

⁴⁹ TelCon7 Conference, Auckland, July 2006.

⁵⁰ Telecom Chairman at 11 August profit announcement.

⁵¹ Mark Ratcliffe at 11 August profit announcement.

⁵² Telecom CEO Theresa Gattung, speaking at the TUANZ Telecommunications Day, Wellington, 24 May 2006.

(e.g. an OSP) is to try to gain strategic advantage to ultimate benefit by pre-empting others and taking the high ground.

- 8.21 There are any number of possible explanations for Telecom's strategy in response to the Stocktake, only one of which is a genuine desire to optimise outcomes for others.
- 8.22 Telecom has talked a lot about pre-empting the legislation and getting on with developing things positively without waiting for the legislation. And it is clear there are very positive initiatives that are to be commended. However the signs remain that we are in for the long haul down the regulatory path. Telecom could proactively move to resolve much of the regulatory and business uncertainty. While saying they are doing this, numerous times they have referred to the need instead to wait for the regulatory process. *"The regulatory certainty that business and investors value must await the outcome of the Select Committee process"*⁵³.
- 8.23 It is clear from the management report and the slides presented on 11 August 2006 that Telecom will likely contest key issues, beginning with pricing around Naked DSL and LLU. Their financial projections are based on this happening⁵⁴. For example they are predicting little impact of Naked DSL and LLU on their numbers until the year ending 30 June 2008 (that is consistent with access seekers being forced to apply to the Commission for determinations in relation to upsized DSL, naked DSL and LLU).
- 8.24 It is therefore essential to have a regulatory process or backstop to ensure that Telecom has sufficient incentive to implement a robust OSP.
- 8.25 Committee members need to recall Telecom has a past history of making undertakings on a range of issues in its dealings with the Government. Telecom's willingness and ability to meet the obligations it agrees to in such undertakings is a matter of public record.
- 8.26 In the case of BT's adoption of undertakings, the existing power in UK law to bring about mandatory structural separation of BT by reference to the Competition Commission was a key bargaining chip in securing a strong operational separation model.
- 8.27 Therefore InternetNZ submits that legal avenues to allow for the consideration of structural separation need to be explored, to evaluate whether such a bargaining chip needs to come into existence in New Zealand law. The following section of this submission makes this case. The section after that outlines amendments to the Bill that will provide for operational separation of Telecom to be required by the Commission / Minister.

⁵³ Telecom Chairman 11 August 2006

⁵⁴ <http://www.telecom.co.nz/content/0,8748,200681-1563,00.html>

9. Structural separation

- 9.1 While InternetNZ submits that legal avenues to allow for the consideration of structural separation need to be explored, it considers that operational separation should be introduced by legislation in any event. Structural separation prospects should be the subject of a separate and on-going review, possibly by the Commission under its proposed investigative powers under the Bill.
- 9.2 Structural separation has quite rightly been described as the most stringent measure that a Government can take to address discriminatory behaviour.
- 9.3 *“Ownership separation would result in two or more companies whose ownership would respectively be focused upon investment in infrastructure (providing longer term investments with lower returns) and services under a more competitive pressure (providing returns linked to a higher degree of risk.”⁵⁵*
- 9.4 The evaluation of whether structural separation should be applied to Telecom would ultimately use the same process case for any form of separation (the cost-benefit test).
- 9.5 Quantifying cost - benefits for any for any form of separation is challenging and would involve assigning values not only to current costs and benefits but in addition it would need to project costs and benefits going forward into the future. In the case of structural separation the complexities of forming a totally standalone network access company adds an additional layer of complexity and disruption than a “BT model” which is the current benchmark for regulators considering separation options

Key factor: Facilities Based Competition

- 9.6 A key factor in policy debates regarding separation and in particular structural separation is the degree to which facilities competition exists in a particular market.
- 9.7 Specifically; Wilsdon and Jones in their paper⁵⁶ suggest:

“The bottom line of the discussion... is that in general, infrastructure competition is superior to services competition. The question is whether it is feasible.

“The key to answer this question is an assessment of the bottleneck-nature of local access.

“An input to a production process, such as a certain part of a network, is a bottleneck - or equivalently, a monopolistic bottleneck, or an essential facility -

⁵⁵ Cabinet Paper from 3 May 2006.

⁵⁶ The politics of bandwidth Network innovation and regulation in broadband Britain, James Wilsdon and Daniel Stedman Jones, online at <http://www.demos.co.uk/files/thePoliticsofBandwidth.pdf>

if it is essential to provide services to end-users, and it cannot be economically reproduced, typically because of substantial sunk costs.

“It follows that there is no need for structural separation if the market allows for network competition (i.e. competition resulting from facilities-based entry).”

Limitations of Accounting Separation

- 9.8 Paul W.J. de Bijl in his paper⁵⁷ points out that the costs and complexities related to implementing accounting separation in all its various guises (e.g. virtual separation) also cannot be underestimated

“It is widely accepted that behavioural regulation, such as regulating wholesale access prices, has its limitations.

“For instance, regulators are not perfectly informed about incumbents' cost levels, information which is needed to select optimal regulated prices.

“Also, designing regulation is a complex matter, requiring substantial time and effort without guaranteeing that regulatory interventions are optimal.

“Therefore, it has been suggested that it might be better to directly change incumbents' incentives, rather than trying to control their behaviour (see e.g. OECD, 2002, for an overview).

“One way to do this is to structurally separate, on a mandatory basis, the regulated firm into monopoly part and a competitive part ('structural separation')”

Cost - Benefits

- 9.9 With regard to structural separation de Bijl provides a useful summary of cost - benefits;

“Structural separation has several potential or claimed benefits and costs....

“The main benefit, which was already mentioned in the Introduction, is non-discriminatory access for all operators without local networks.

“Separation eliminates both the ability and the incentives to restrict competition in the downstream market.

“In particular, it eliminates the incumbent's incentives and possibilities, whether legal, economic or technical, to raise the costs of its rival firms by reducing quality or increasing the cost of access. This increases the intensity of competition, and may ultimately lead to lower prices for end users.

⁵⁷ Pp. 6-7, Structural Separation and Access in Telecommunications Markets, Paul W.J. de Bijl - http://www.autoridadedaconcorrenca.pt/vImages/Structural_Separation.PDF

“On a more general level, the scope for anticompetitive practices, for instance on the market for broadband Internet access, may be reduced.

“Structural separation helps to prevent cross-subsidization and makes reliable cost information about the incumbent's non-competitive activities more readily available.

“Ultimately, the idea is that regulation becomes much simpler and effective, and less costly. Not only are firms that are not vertically integrated easier to monitor, anti competitive behaviour is much less likely to occur.

“There are also many potential and claimed costs and disadvantages to structural separation.

“Separating a vertically integrated operator eliminates the coordination benefits, as well as the economies of scale and scope, that accrue from vertical integration.

“For example, coordinating investments in the network between the new (separated) parties may become problematic, given that innovations in services may require investments in competitive as well as non-competitive activities.

“Given that separation is a costly and time-consuming affair, it may raise the cost level of the incumbent operator. As a result, entrants become relatively - but not intrinsically - more competitive.

“Making a cost-benefit analysis in a given situation, will neither be easy nor lead to a simple, unambiguous result.”

Disruptive innovation

9.10 A final point in support of structural separation is the notion of disruptive innovation. Again Bijl, in his support for the structural separation of BT, makes the following point:

“Structural separation of BT, on the other hand, would produce high levels of disruptive innovation, and would have a beneficial effect on innovation and investment across the telecoms market.”

9.11 While of course difficult to quantify, the “disruptive innovation” factor is perhaps the most compelling argument for structural separation.

Recommendation

9.12 InternetNZ submits that the structural separation option should be the subject of a more detailed investigation and be included in any cost benefit analysis which would examine the full range of separation options. This may be a matter appropriate for the Commission to review under its proposed investigative/monitoring powers.

9.13 While structural separation has largely been dismissed in other markets almost out of hand as being highly disruptive and complex, without any

supporting analysis, if one takes the example of the “BT model”, the question needs to be asked: *“what greater costs would be incurred in taking the next step from operational separation to full structural separation by the formation of Openreach as a standalone entity?”*

- 9.14 New Zealand has been exposed to structural separation in other sectors. In the corporate sector there was the break up of Fletcher Challenge and more recently the Electricity Sector which created standalone power generation, lines and retail companies.
- 9.15 The unique factors in of the New Zealand telecommunications marketplace (i.e. size, geography, and most importantly the non existence of facilities competition in relation to last mile access both currently and going forward into the foreseeable future) all support the argument for a detailed examination of the structural separation option.
- 9.16 InternetNZ submits that such an examination be conducted by officials in consultation with the industry in the near future.

10. Proposals for including Separation in the Bill

- 10.1 In summary, while InternetNZ submits that an OSP similar to the BT model is appropriate, the Australian OSP legislation is the easiest and quickest way of achieving a robust OSP in New Zealand, whether or not it follows the BT model. Despite the complexities of OSPs, the Australian legislation is a model of simplicity and could, with limited variations, be utilised in New Zealand. It achieves this outcome in the equivalent of only 11 sections in an Act.
- 10.2 It can also be supplemented by a formal undertakings regime, extending the proposed regime in the Bill, as the regulatory OSP regime may lead to an agreed OSP by way of undertakings. However, InternetNZ submits that it is not necessary to have such a regime for there to be a binding undertaking. The undertaking can for example be in contract or deed form. In any event, the agreed OSP can be as approved by the Minister, after negotiation (which is what happened in Australia). This appears to be the easiest mechanism. The Australian model is consistent with negotiation (with regulatory resolution if necessary).
- 10.3 The OSP legislation in Australia is contained in the Federal Telecommunications Legislation Amendment (Competition and Consumer Issues) Act 2005⁵⁸. Contrary to submissions by Telecom's Australian subsidiary, AAPT, the legislation revolves around approval of the OSP by the Minister (maintained by AAPT to be a weaker approach) rather than the Australian equivalent of the Commerce Commission, ACCC.
- 10.4 The regulatory model is very simple. Within specified timelines:
- 10.4.1 The Minister provides an overview of what is required in the OSP, to supplement the briefly stated overarching aims and objects to be applied in preparing the OSP⁵⁹.
 - 10.4.2 Telstra produces a draft OSP⁶⁰, which is open for public comment⁶¹.
 - 10.4.3 Having considered the draft OSP and comments from the public, the Minister either approves or rejects the draft OSP. If she refuses to approve, then she can direct Telstra to vary the draft plan⁶². The OSP is then in final form and ready to implement.
- 10.5 All of this is achieved in the equivalent of 11 sections in an Act, supplemented by provisions to amend or rectify the OSP later.⁶³ This is a relatively straightforward change to the legislation.

⁵⁸ A copy of the Act is at <http://www.comlaw.gov.au/ComLaw/Legislation/Act1.nsf/all/search/3A7249812A637E4FCA2570890077F668>. The OSP model is set out at page 32 (to be a new part 8 in Schedule 1 of the Telecommunications Act 1997).

⁵⁹ Clauses 48 and 51(1)(d).

⁶⁰ Clause 52.

⁶¹ Clause 53.

⁶² Clause 54.

⁶³ Clauses 56-66.

10.6 The principles to be applied in constructing the OSP in Clause 48 are succinctly stated. They can be altered to cover New Zealand circumstances and encapsulate desired outcomes (such as the equivalent of the BT model). Although the description could be prescriptive (e.g.: to drive the outcome to a New Zealand version of the BT model) it could instead be fluid in approach. Taking the latter approach, neither the Select Committee nor Parliament needs to make the decision on the detailed content and approach in the OSP. This can be left for resolution by the Minister (or the Commission as noted below).

10.7 The pragmatic approach is emphasised by the following, and appropriate, extract from Clause 48 of the Australian legislation:

“48(2) The objects of this Part are as follows:

..... to ensure that the achievement of:.....

(i) the aim of this Part; and

(ii) any of the above objects;

does not impair Telstra’s ability to compete on a fair and efficient basis.”

10.8 InternetNZ submits that it is important for there to be a legislative framework within which a robust OSP can be finalised, even though it is likely that it will be agreed with Telecom. But, it is very unlikely that a suitably robust OSP will be agreed without a legislative process or backstop.

10.9 The Australian model is simple and effective. InternetNZ has considered whether to submit that the regulator should be substituted for the Minister in the OSP process noted above. That is what Telecom’s Australian subsidiary, AAPT, wanted. as to Telstra’s operational separation. AAPT recognised the risk that Telstra would seek to overly dilute operational separation. AAPT pushed for stronger intervention by the Australian regulatory body, ACCC, rather than the Minister. ACCC has particularly strongly stated views in support of robust and effective operational separation. In their submissions on the proposed OSP for Telstra, AAPT gave an example of where Ministerial, rather than ACCC, overview had failed on another occasion (accounting separation). AAPT then said:

“We have significant concerns that the process of operational separation can be “gamed” to result in either no effective separation or in the Minister effectively writing the plan.

In addition we repeat our suggestion that a Commissioner of the ACCC be appointed who is exclusively concerned with telecommunications issues to facilitate decision making and ensure a suitable focus.”⁶⁴

10.10 While InternetNZ submits that either the Minister or the Commission could be the body making the OSP decision (or the Commission followed by Ministerial approval), our preference is for the Minister to make the decision, applying the approach in the Australian Act. In particular, this will likely lead to faster outcomes.

⁶⁴ http://www.apf.gov.au/Senate/committee/ecita_ctte/sale_telstra/submissions/sub07.pdf

10.11 Some concern was expressed in Australia about the lack of consultation leading up to acceptance of the final OSP by the Minister, following negotiations between Telstra and the Minister/DCITA. Although there is a consultation requirement at clause 53 of the Australian Act, it can be argued that there should be an express consultation obligation in respect of the later drafts of the OSP (that is, prior to acceptance or imposition of the plan in final form pursuant to clause 54(a)(a)). InternetNZ considers that there should be an express obligation to consult.

**The Conclusion to these submissions
is at the end of Part One, on page 13**

Advancing Telecommunications Services for New Zealand in the 21st Century

Reforming the Regulatory Framework and associated issues

Submission to the Minister of Communications and Information Technology

by

InternetNZ
(The Internet Society of New Zealand Inc.)



*InternetNZ is the not for profit organisation that manages
the .nz domain name space, and seeks to protect and
promote the Internet in New Zealand.*

February 2006

Public Version (there is no confidential version)

Executive Summary

- InternetNZ welcomes the opportunity to provide input into the future direction of telecommunications regulation in NZ and related issues with the aim of addressing many of the shortcomings in the NZ Telecommunications marketplace – which is characterised by the failure of the current regulatory regime to deliver meaningful competition and choice for NZ businesses and consumers across a wide range of telecommunications services.
- The main focus of this submission is directed to overcoming the economic bottlenecks which affect the broadband supply chain; specifically local loop access issues.
- New Zealand's low broadband uptake and high end user costs have been well publicised and debated over many years. In 2001, at the time the Telecommunications Act was passed, New Zealand ranked 16th out of 30 OECD countries for broadband uptake.
- Fast forward to 2005. New Zealand now ranks 22nd out of 30 in broadband uptake in the OECD. Only 10.9 per cent of NZ households have broadband, half the OECD average of 21.2 per cent. We have gone backwards.
- There is near-universal agreement that broadband is to the 21st century what roads and rail were to the 20th century – critical infrastructure. Advanced telecommunications services are a key enabler and economic driver for a knowledge-based economy in order to compete successfully in the global economy. The Screen Council, for example, has continually repeated a call to action; warning that the entire film industry is at risk due to the lack of affordable high speed data services.
- This submission outlines a series of policy initiatives and regulatory reforms to address structural issues that are impacting on the current telecommunications marketplace, in which the incumbent Telecom has been able to exercise its near monopoly in the local loop to dictate the pace and development of broadband services.
- Notwithstanding InternetNZ's particular concerns with the state of the NZ broadband marketplace, InternetNZ submits that any debate for regulatory reform should be guided by a set of overarching objectives or principles.
- Specifically the outcomes of a regulatory review should:
 - provide increased competition to drive down the costs of services to consumers and businesses.
 - support innovation through the growth of new applications and services from a range of existing industry players and new entrants.
 - provide regulatory certainty for service providers and investors.
 - re-focus regulation toward swifter remedies to tackle anti-competitive behaviour with a structure of real penalties and incentives;
 - remove regulation wherever competition is effective.
 - help ensure the necessary level of consumer protection through a combination of codes, sanctions and effective consumer information.
- The current telecommunications environment in New Zealand is characterised by a single company that exercises SMP (significant market power), which inhibits any meaningful competition and stifles investment opportunities.
- Encouraging competition and investment in advanced telecommunication services requires a regulatory structure that is flexible and forward-looking.

Appendix I: InternetNZ’s Original Stocktake Submission, February 2006

- To better serve business and consumers, a new regulatory approach is required that provides full equality of access (equivalence) to Telecom’s network infrastructure while promoting innovation and investment in the telecommunications sector.
- This review comes at a critical juncture in which the outcomes from this stocktake and associated consultations, will likely dictate the pace of telecommunications investment and technology deployed for the next decade.

Recommendations

- Outlined below is a table containing a summary of recommendations and roadmap that underwrite the necessary reforms to address both the market and regulatory failure that characterises the NZ telecommunications marketplace.
- These recommendations are based on the proposition that when all reliable indicators point to market failure(s), the onus is on Government to intervene and take decisive action to correct those imbalances where self-regulation or the powers of the Telecommunications Commissioner are unable to provide effective relief to resolve industry disputes or create a regulatory climate which rewards competition and innovation.
- **There is no single silver bullet.** None of the proposed measures by themselves deliver any significant change to the status quo. The roadmap is designed to deliver short term, medium term and long term outcomes.

Year	Local Loop Network	Other Proposals
2006	<ul style="list-style-type: none"> • Initiate a Schedule 3 investigation of a true UBS • Full Local Loop Unbundling reconsidered by the Cabinet, and implemented by legislation (or by Schedule 3 investigation) • Investigate TCNZ wholesale / retail services separation options 	<ul style="list-style-type: none"> • Increase funding for the Digital Strategy’s Broadband Challenge • Public Sector telecommunications investment review • Spectrum utilization review to support community broadband wireless initiatives
2007	<ul style="list-style-type: none"> • Implement TCNZ wholesale / retail services separation 	<ul style="list-style-type: none"> • Implementation of spectrum utilization and Public Sector telecommunications investment reviews • National FTTH Task Force
2008 – 2015	<ul style="list-style-type: none"> • TCNZ Structural separation 	<ul style="list-style-type: none"> • National FTTH / FTTN rollout

Introduction

1. This submission has been developed in consultation with InternetNZ members including public meetings in Auckland, Wellington and Christchurch in January 2006. A range of experts in New Zealand and overseas have also contributed.
2. The major theme which underwrites this brief is how to achieve a true split of Telecom wholesale and retail services which treats all comers in an equal fashion beginning with access the local loop i.e. LLU and going forward into the future, fibre / NGN networks.
3. The "access issue" needs to be considered from two perspectives; the first being how do third parties gain get access, on non discriminatory terms, to Telecom's network for providing services via unbundled local loops. The second is how to ensure investment in local access can keep pace with bandwidth demands of next generation broadband applications and services.
4. Local loop unbundling should not be seen as the panacea for the perceived structural failures in the NZ access market and is unlikely to lead to the levels of access network investment that will make advanced broadband services more widely available in the future.
5. Upgrades of ADSL to ADSL-2 and VDSL are likely to require deeper deployments of fibre, which could lead to additional problems for LLU implementations.
6. The "access" issue also requires detailed examination of a range of non Telco structural options including an aggressive expansion of community open access fibre networks (Broadband Challenge); access and use of alternative civil infrastructures (rights of way); power utility infrastructure; divestment of duct assets by Telecom and new-build / greenfields FTTH developments.
7. True wholesale services can only be accomplished from a fundamental restructuring of Telecom. The issue is not if, but how. Should organisational restructuring and change of behaviour by Telecom be best accomplished by operational or structural separation?
8. An overriding test that has been applied elsewhere i.e. operational vs. structural separation is net cost benefits. In the UK and Australia the decision favoured operational separation.
9. InternetNZ will argue that because of the peculiarities of the New Zealand marketplace the only viable option in the long term is for structural separation of Telecom.

Context

The Digital Strategy

10. InternetNZ has noted the following in the Digital Strategy

We must respond to two challenges of connection:

- *New Zealand has high Internet usage, but low broadband uptake*
- *New Zealand's small market inhibits investment and limits competition.*

Appendix I: InternetNZ's Original Stocktake Submission, February 2006

Being connected by broadband matters. Affordable, high-speed Internet access drives productivity and economic growth. It is a prerequisite for a 21st century economy – and for all the other goals in this Strategy.

“Connection”, Digital Strategy, 2005

11. If the ambitious targets for deployment of “true” broadband and advanced network services outlined in the Digital Strategy including being positioned in the upper quartile of OECD countries for broadband uptake are to be realised, (currently 22nd for domestic broadband rollout, 27th for business broadband,) a shift from the “light-handed” regulatory approach is required.

Consequences of the current regulatory framework

12. The New Zealand regulatory framework is considered to be light-handed by international standards, promoting self-regulation in preference to government intervention.
13. Except for mobile, Telecom has continued to consolidate its dominant position in the marketplace. The net result has been well documented – not only in relation to broadband but in relation to a range of telecommunications services i.e. high cost cellular services, all of which can be directly attributed to the lack of competition. The flow on effect has resulted in the lack of incentives and confidence for new entrants to invest in the NZ marketplace.
14. The decision in 2004 to introduce a heavily constrained UBS (with a commercial UPC service) in lieu of local loop unbundling has not delivered any of desired outcomes that were anticipated at that time. Smaller players continue to lose market share. Businesses and consumers continue to be denied innovative broadband applications and services.
15. Going forward, access to TCNZ's local loop network continues to be a key issue. There is general agreement among industry analysts that alternatives to the copper local loop for last mile access, utilising emerging new technologies such as wireless, will only at best occupy a small niche in the marketplace.
16. Telecom's 128kbps uplink speed restriction that governs ADSL broadband services in New Zealand falls well short of any definition of broadband and means that users cannot enjoy any of the benefits of true broadband.

The Way Forward

17. Two series of measures are outlined below. The first series deals with access to the local loop network. The second series includes regulatory and other initiatives to stimulate broadband competition by new entrants.
18. The following table includes a timeline which summarises InternetNZ's proposals. The table is divided into two columns following the two major areas discussed in this submission – proposals relating to the local loop network, and other proposals to expand broadband services.

Appendix I: InternetNZ's Original Stocktake Submission, February 2006

Year	Local Loop Network	Other Proposals
2006	<ul style="list-style-type: none"> • Initiate a Schedule 3 investigation of a true UBS • Full Local Loop Unbundling reconsidered by the Cabinet, and implemented by legislation (or by Schedule 3 investigation) • Investigate TCNZ wholesale / retail services separation options 	<ul style="list-style-type: none"> • Increase funding for the Digital Strategy's Broadband Challenge • Public Sector telecommunications investment review • Spectrum utilization review to support community broadband wireless initiatives
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2008 – 2015	<ul style="list-style-type: none"> • TCNZ Structural separation 	<ul style="list-style-type: none"> • National FTTH / FTTN rollout

Access to the Local Loop Network

19. Access to TCNZ's local loop network in which Telecom enjoys a natural monopoly remains the focus for reform. Last mile access to the customer in the next 15 years and possibly 25 years will continue to rely on copper. Greenfields FTTH and NGN rollout including FTTN will do little to alter the continued reliance on copper to deliver high speed data services to homes and businesses in the foreseeable future.
20. InternetNZ proposes the following reforms:
 - a. A revised UBS offering
 - b. Local Loop Unbundling
 - c. Wholesale / retail services separation, by agreement or otherwise, of TCNZ's local loop network and wholesale product operations from the rest of its business.
21. It should be stressed that these are not alternatives. InternetNZ urges the government to pursue these three courses of action in parallel, in order to provide a range of access options to the local loop and to remove the existing incentives to deliver poor service.
22. Each of these proposals is considered in more depth below.

Recommendation: A revised UBS offering

InternetNZ proposes a Schedule 3 investigation with the aim of establishing a revised specification for UBS service.

Alternatively, legislation arising from the Implementation Review of the Telecommunications Act could provide a mechanism for the Commission to implement a revised specification for UBS.

This must be given the highest priority and can be implemented within the next 12 months.

Discussion

23. The Telecommunications Act provides for the government to request a Schedule 3 investigation, which could lead to the designation of a new UBS service based upon TCNZ's currently deployed DSL service and offered at an up and downlink speed that is unconstrained.
24. When the Commerce Commission recommended UBS instead of LLU, the service was restricted to an upstream speed of 128kbps. The Commission's determination accepted Telecom's argument to limit upstream speed so as not to disrupt future investment plans such as Telecom's rollout of NGN.
25. To future-proof any unconstrained UBS service, both downstream and upstream speeds needs to be defined as "unconstrained"; that is, provided at the highest speed technically feasible. DSL rather than ADSL should be specified, so providers can choose to offer a

Appendix I: InternetNZ's Original Stocktake Submission, February 2006

synchronous service where viable. Any UBS specification also needs to ensure adequate performance standards to avoid a situation where an unconstrained line speed has no service benefits due to bandwidth constraints imposed further up the network.

Recommendation: Local Loop Unbundling

InternetNZ proposes that Government reconsider local loop unbundling. Since 2004 developments in New Zealand and overseas have provided further evidence that will support the case to implement LLU (or, if that is not possible, referring the matter to the Commission under Schedule 3 of the Act).

Discussion

26. The "local loop" is a vital component of the broadband value chain. The LLU 'access issue' needs to be considered from two perspectives; how do third parties can get access, on non discriminatory terms, to Telecom's network for providing services via unbundled local loops? Second, how can investment in local access keep pace with demands for next generation broadband services and applications?
27. When rejected in 2004, a key argument against LLU in a finely balanced decision was the fact that overseas experience suggested very little had been achieved by way of implementation. This conclusion is no longer valid. Consider the following: in Australia LLU has delivered 4 national broadband networks. In the UK over 2 million lines are now expected to be unbundled by the end of 2006.
28. In light of the market experience in other countries, it is imperative that the government act promptly and decisively to introduce LLU. Detailed arguments in favour of LLU are attached. See Appendix I.
29. Also noted is COVEC research commissioned by MED which did not concur with the Commission's conclusion regarding LLU.
30. Process would favour the use of legislation, i.e. more expedient than a request to the Commerce Commission to review LLU by way of Schedule 3.
31. The UK experience with LLU requires detailed examination. For example Ofcom introduced an innovative process for cutting through some of the complex issues associated with LLU by setting up the Office of Telecommunications Adjudicator (OTA). The Adjudicator was designed to be in a position to lead and guide the process of LLU implementation while also having the right to resolve disputes brought to him formally.

Recommendation: Separation of TCNZ's wholesale and retail services

InternetNZ proposes an investigation that would bring forward recommendations to achieve a separation of TCNZ wholesale and retail services.

Discussion

32. InternetNZ's preliminary view is that a full structural separation of TCNZ is the only long term option. InternetNZ does however recognise the challenges that structural separation presents (i.e. could take up to 5 years to implement) so there is likely a need to consider a staged process that delivers more immediate benefits in the short to medium term.
33. Options include the following:
- a. **Internal reorganisation:** i.e. a wholesale division. Overseas experiences have proven that this is not workable in terms of delivering true equivalence of supply.
 - b. **Operational separation:** a short to medium term solution which has been favoured in Australia and the UK. Ofcom agreement with BT that has resulted in the creation of BT OpenReach, a 30,000 employee company launched in January 2006 is seen as model for operational separation. See Appendix 2: *Undertakings between British Telecom and Ofcom*.
 - c. **Structural separation:** with a separate company owned by TCNZ formed to manage the new network/wholesale business,

(A variation on structural separation would be for the Crown to take a strategic or controlling interest in the wholesale business i.e. network ownership including the local loop.)
34. If TCNZ were required to structurally or operationally separate the operations of the local loop network and wholesale services provision from their retail services, the following benefits would be available:
- Full transparency of revenue and costs on the local loop – which would assist with calculating the costs to be shared for TSO obligations
 - Fair and equitable treatment of all local loop network access seekers – TCNZ retail would be treated exactly the same as any other access seeker
 - Regulation of line rentals and access to services, universal service obligations etc could be made with better knowledge of the costs involved

Shifting the Goalposts: Alternative Broadband Infrastructure Initiatives

35. The following section deals with initiatives to stimulate broadband competition by focusing on options that could assist or encourage new entrants into the marketplace.
36. InternetNZ proposes the following reforms, in no particular order:
 - a. Increase funding for the Digital Strategy's Broadband Challenge
 - b. Maximise synergies from public sector investment in telecommunications network infrastructure and services
 - c. Review spectrum availability for community wireless broadband platforms
 - d. National strategic plan for the development of next generation broadband network services including FTTH (fibre-to-the-home)

Recommendation: Increased Funding for the Broadband Challenge

InternetNZ recommends an additional \$60m be allocated to the Broadband Challenge fund in 2006, to further expand the rollout of urban open access fibre community network initiatives.

Discussion

37. Budget 2005 announced the government's funding commitment to implementing Digital Strategy initiatives including the Broadband Challenge, a \$24 million seed fund to assist the development of urban open access fibre networks.
38. Broadband Challenge expressions of interest to date indicate that the Broadband Challenge, a four-year funding programme may be already be fully subscribed in year one.
39. Additional funding is essential. InternetNZ is recommending that an additional \$60 million be allocated to the Broadband Challenge fund which could include a mix of seed funding and a loan facility. At a minimum approx \$250 million of private capital investment will be required if the target of 15 urban fibre networks is to be met. A loan facility would assist to mitigate private sector investment risk, thereby driving increased investment.
40. It is argued that the future of telecoms in general and the Internet in particular will be driven by open access networks. The importance of continued Government support for the development of open access fibre networks through the Broadband Challenge cannot and should not be underestimated.

Recommendation: Review of Public sector investment in Telecommunications Infrastructure

InternetNZ recommends a review of public sector investment in telecommunications and related infrastructure initiatives with the aim of fostering more competition in the telecommunications marketplace.

Discussion

41. A challenge for central government is how to maximise the potential synergies resulting from a number of public sector telecommunications and related initiatives.
42. These include the Government Services Network (GSN), Advanced Network (REANNZ) and the Broadband Challenge. In addition central government through an SOE, BCL, owns a national telecommunications infrastructure company which is well positioned to develop a national high capacity backbone to service regional and rural networks.
43. Also, central government will in the near future be asked to make investment decisions regarding digital broadcasting, the options for which are becoming more complex as a result of convergence and the shift to distribution of all forms of digital content and entertainment across IP networks.
44. An example of a Government ability to leverage its purchase of telecommunications services to achieve wider economic and social goals is in the Australian State of Victoria, which in May 2005 announced as part of the State's wider Telecommunications Purchasing and Management Strategy (TPAMS), the SmartONE project, a \$89m fibre network linking all government schools within four years and "enabling businesses in rural and regional Victoria to have access to the best available broadband infrastructure on offer."

Recommendation: Spectrum Availability for community wireless

InternetNZ recommends a review of spectrum management, specifically the establishment of a community framework for spectrum utilization which provides for community based and / or non-commercial broadband wireless initiatives. Wireless broadband networks are examples of how public spectrum is used by local communities looking to establish affordable broadband public access.

Discussion

45. In the past, allocation of radio spectrum has specifically included certain frequency ranges which are marked as *unlicensed*, meaning that they can be used by anyone without a specific licence from the Government. Examples of such unlicensed spectra include the 900MHz band used by CB and portable telephones, the 2.4GHz bands used by 802.11b/g-based computer systems for wireless networking, and the 5.3/5.8GHz bands used in next-generation wireless (802.11a) computer networking.

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46. New Zealand's geography – specifically, the significant distances between population centres – mean that wireless-based networking solutions are going to become increasingly significant over time, their growth matching or exceeding copper and fibre-based broadband network growth. Wireless-based broadband offers access to high-performance networking in many environments where the distances or existing cable resources reduce the utility of other solutions.
47. Unfortunately, many of the unlicensed spectrum allocations were made before the current explosion of growth in the network marketplace, and a number of them (especially the 2.4GHz ranges) are now heavily saturated. To compensate for this, InternetNZ would like to see a review to look at options available for non-commercial use of spectrum for community purposes.

Recommendation: National FTTH Task Force

InternetNZ recommends the appointment of a task force, comprised of industry and consumer representatives and officials, to investigate the options for delivering fibre to the home in a reasonable timeframe, with task force appointments to be made no later than September 2006 and a preliminary report to be tabled no later than June 2007.

Discussion

48. Sweden, whose population base and geography are very similar to New Zealand's, has already achieved a national fibre rollout covering 90% of the population and is delivering affordable 100mb services to consumers and businesses. The total cost represents a total public / private sector investment of US\$5 billion.
49. Initial planning needs to begin now on how a national fibre network could be developed (as in the example of Sweden) with a goal that FTTH would be available to up 90% of the population.
50. Planning begins with a vision. A task force would be asked to create that vision and generate discussion, costs and options on how New Zealand will create a telecommunication infrastructure that will serve the country well into the 21st century.
51. FTTH is a long term goal, a phased development with active participation of the private sector and industry stakeholders vital to its success. The sooner the planning begins the sooner services can be made available.

Convergence: Regulating the future

52. In considering the future of the telecommunications regulatory framework, convergence is a critical issue. The following quote speaks for itself:
53. *“The development of new technologies, new services, issues such as convergence, and the implications that new voice services may have on universal service, all raise new important regulatory issues. The shift by operators to the “next generation network” may create further pressure to have a single regulatory structure which deals with electronic communications networks and services. New technological developments now allow communications services which historically were regulated differently to appear identical from the consumer point of view. This underscores the regulator’s need to be mindful not only of issues related to companies, but also with the concerns of consumers. An independent regulator with the habit of interacting and learning from consumers will have an advantageous perspective on markets as different technologies vie for new or different regulatory actions.”*
54. *“The development of new network structures may well, over time, result in the need for a review of existing regulatory structures and their responsibilities, in addition to a change in the regulations themselves. But many of the changes taking place in networks and applications are evolutionary, even though the changes may be rapid, rather than revolutionary. This requires that regulators are structured so as to manage rapid change in the industry and flexible enough so that their internal structures can change to be able to accommodate changes in the communications sector. In turn, regulators need to ensure that on the policy side changes are also being made which will meet the needs of users and the industry.”*

P 34.35 .TELECOMMUNICATION REGULATORY INSTITUTIONAL STRUCTURES AND RESPONSIBILITIES
11-Jan-2006
OECD DIRECTORATE FOR SCIENCE, TECHNOLOGY AND INDUSTRY
COMMITTEE FOR INFORMATION, COMPUTER AND COMMUNICATIONS POLICY
Working Party on Telecommunication and Information Services Policies
<http://www.oecd.org/dataoecd/56/11/35954786.pdf>

55. Convergence will present a regulatory challenge: how to establish a framework that focuses not just on regulating today but arrives at a set of rules which will regulate future technologies.
56. IP next generation networks such Telecom's NGN will significantly change the competitive dynamic of the telecommunications marketplace. The issue becomes (in those services where the Telecom NGN exercises SMP) how to go about establishing an environment which will allow competitors (including non-traditional players) equality of access to the network, to offer applications and services.

Conclusion

57. The programme of reforms outlined in this submission focused on two main areas for reform: access to the local loop network, and other initiatives to develop New Zealand's broadband infrastructure.
58. A piecemeal approach to regulatory reform will only deliver limited benefits – but taken together, the reforms outlined here could provide the necessary step change in the delivery of competitive telecommunications services in New Zealand.

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59. Improving competition on the local loop through better wholesale services, local loop unbundling and a separate wholesale operation for the loop would remedy the major problem in the market today – a lack of competitive access to the local loop network, and poor incentives on TCNZ to behave cooperatively with other market participants as simultaneous owner of the network and retailer of its services.
60. The other options to explore development of alternative platforms for broadband development are vital to driving innovation and leading edge application and service development on the broadband network. They complement the focus on improving local loop network competition.
61. The eventual rollout of fibre to the home over time, and the potential use of state network resources in delivering elements of such a network, would represent a major future-proofing of New Zealand's information and communications infrastructure. Once again we could lead the world in the provision and takeup of such services.
62. The major initial requirement to make any of these things happen is political will, and the capacity by government to put the long term national interest ahead of the commercial interests of current market players. A soundly argued package of reforms that would clearly deliver better services would deliver such obvious benefits to the country that it would attract serious popular and political support.

InternetNZ February 2006

Attachments

Appendix A – Rationale for the re-consideration of Local Loop Unbundling

Appendix B – Undertakings between British Telecom and Ofcom

Appendix A

Rationale for the re-consideration of Local Loop Unbundling

1. While InternetNZ recognises that marketplace and regulatory certainty is an important factor, it is only one of many factors to be considered. It should not drive outcomes when marketplace failure is apparent. InternetNZ considers there should be a Schedule 3 review, or legislative intervention, even though just over 2 years have elapsed since the Commission's LLU/PDN decision.
2. In any event, there have been a number of significant changes since the Commission's LLU/PDN Report and the subsequent review by the then Minister. We outline some of these changes below. They amply justify a Schedule 3 review or legislative intervention. In any event the Schedule 3 review can include consideration of whether change is warranted, in the face of one of many factors: the desire for marketplace and regulatory certainty.
3. As the Minister pointed out when deciding to accept the Commission's recommendations (that there would not be full ULL, but there would be a 128kpbs upstream UBS service, coupled with Telecom's UPC undertaking), his decision was a line call.¹ That this was a line call is highlighted by:
 - 3.1. The fact that New Zealand stands unusually, only with Mexico in the OECD in not adopting LLU.
 - 3.2. The Commission's draft determination for full LLU, and then the reversal in the final Report;
 - 3.3. The Commission's Final Report is finely balanced, and heavily reliant on qualitative and impressionistic analysis, particularly as to the assessment of dynamic efficiencies (especially investment in Telecom's proposed NGN network);
 - 3.4. MED's view that the Commission should be asked to review its decision.²
 - 3.5. The expert consultant who peer-reviewed the Commission's decision for MED concluded that fundamental errors had been made by the Commission.³ Having noted the considerable time pressure that the Commission was under to meet its December 2003 deadline (presumably to suggest why there were errors), he considers that, among other things:
 - 3.5.1. the Commission under-estimated the benefits of unbundling, particularly with reference to its cost-benefit analysis, and conclusions that it drew which could not be supported.
 - 3.5.2. the UBS solution (the 128kpbs upstream service) was too narrow (and didn't address key issues), and the Commission placed undue weight on potential investment by Telecom.

¹ <http://www.med.govt.nz/pbt/telecom/llu-investigation/media/minister-20040519.html>

² See MED's Report to the Minister of Communications of 5 May 2004:
<http://www.med.govt.nz/pbt/telecom/llu-investigation/ministry-report/index.html>

³ See the executive summary at <http://www.med.govt.nz/pbt/telecom/llu-investigation/ministry-report/index.html>

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- 3.6. The Minister's reversal of his initial decision to ask the Commission to reconsider UBS and full LLU, after other Ministers raised concerns. ⁴
4. An important factor in the Minister's final decision to accept the Commission's recommendations was that sending it back for review would be likely to lead to considerable delays to broadband competition.⁵ However, he noted that he would watch developments closely, *"taking particular note at how quickly and successfully Telecom moves to promptly facilitate the delivery of higher-speed, more competitive broadband in New Zealand."* ⁶ Of course, any service with an upstream speed limited to 128 kbps simply does not come anywhere near to being "broadband", even on the widest of interpretations (as the Commission noted in its LLU Report, Telecom stated as to its own 128 kbps services that they were not "broadband"). The Minister also noted in the same statement⁷: *"I understand that Telecom intends to exceed the recommendations for bitstream unbundling set by the Commissioner. The extent to which this is achieved will influence any future decision I may make on whether to refer these issues back to the Commissioner."*
5. There are 2 key issues that flow from the Minister's approach at the time:
- 5.1. Getting the regulated service up and running quickly, at the time, outweighed the delayed broadband roll-out, in referring the matter back to the Commission. Now that the regulated service is up and running, that is no longer an issue: the need for enhanced unbundling can be revisited without that same degree of timing pressure.
- 5.2. History has shown that Telecom has not done what the Minister expected. Far from it. There is every sign that this will continue unless something is done to fix the situation. TelstraClear's experience illustrates the point (there are other examples). Telecom refused to provide, commercially, to TelstraClear the minimum service that the Commissioner ultimately determined in December 2005 (unlimited downstream speed, single price UBS). The service commercially offered to TelstraClear (and the commercial service offered to other access seekers) fell far short of that (ie: far short of the Commission's minimum service). TelstraClear therefore applied to the Commission for a regulated UBS service: the country's largest provider (outside Telecom) will have been kept out of the DSL market for around 2 years by the time a service is made available to it. TelstraClear announced, when they concluded the commercial settlement this month, that they couldn't wait any longer and would compromise and take a service that is inferior to the service as determined by the Commissioner. Far from acting to *"exceed the recommendations for bitstream unbundling set by the Commissioner"*, Telecom fell far short of the minimum service in accordance with the regulations. Its commercial offerings to other ISPs also fell far short of the minimum service that the Commission ultimately ordered (and fell far short of the commercial service agreed between Telecom and TelstraClear). This situation with TelstraClear has led to marked delay in "broadband" roll-out (the very thing the Minister was trying to avoid). That is so even assuming that a 128kbps-limited service qualifies as broadband; it does not, and so the Minister's desire for Telecom to proactively help deliver true broadband has still not been met. It is of considerable concern to InternetNZ that the regulatory regime is still only tinkering with a service that falls well short of "broadband".
6. We now turn to the Commission's LLU/PDN Report. There have been highly significant changes since that Report, which point to a need for change. First, in its executive summary of

⁴ See the Cabinet paper at <http://www.med.govt.nz/pbt/telecom/llu-investigation/cabinet/20040519/200405>

⁵ <http://www.med.govt.nz/pbt/telecom/llu-investigation/media/minister-20040519.html>

⁶ <http://www.med.govt.nz/pbt/telecom/llu-investigation/media/minister-20040519.html>

⁷ <http://www.med.govt.nz/pbt/telecom/llu-investigation/media/minister-20040519.html>

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its Report⁸, the Commission noted a key reason for its decision to limit unbundling to the 128kbps UBS service (coupled with Telecom's UPC undertaking): *"The experience of a range of other countries with regulated local loop unbundling does not lend weight to the case for New Zealand to follow suit. The levels of uptake of unbundled loops are small in relation to the number of available lines...."* In the body of its report (see particularly Para 752) the Commission relies on the low installation by new entrants of DSLAMs in incumbents' exchanges as a reason for not implementing LLU. This lack of uptake of LLU appears to be a particularly important reason underlying the Commission's decision (for example, it is one of the few discernable reasons, supporting the decision, that are articulated in the executive summary to the report).

7. Overseas, there has been a large shift since the LLU Report, when utilisation of LLU opportunities was low. Installation of new entrants' DSLAMs in incumbent locations (exchanges and cabinets) is increasing exponentially, and the number of lines served by LLU is doing the same. The UK and Australia as examples.
8. In the UK the number of unbundled lines has been increasing during 2005: 40,000 at 31/3/05,⁹ 70,000 at 30/6/05,¹⁰ 120,000 at 30/9/05,¹¹ and 210,000 lines at 31/12/05.¹² Ofcom is confident that growth in full LLU lines will continue to accelerate, passing 1.5m lines by the end of 2006. ¹³
9. In Australia¹⁴, it is expected that three major ISPs (Optus, Primus and iiNet) will have installed DSLAMs into around 200 exchanges, delivering up to 24mbps broadband services to up to 200,000 customers by the end of the year. Macquarie forecasts that these three ISPs will have 1.63m DSL ports available by 2010 through LLU, comprising 28% of retail and wholesale broadband connections by that date. This is from a low base – 50,000 LLU lines in June 2005.
10. Line sharing was dismissed as an option by the Commission (and MED) as no-one sought it (see Para (vi) of the executive summary to the LLU Report). Line sharing involves access seekers getting only high frequency access to the local loop via the access seekers' DSLAM. Low frequency voice telephony is excluded. Given the subsequent rapid increase in installation of third party DSLAMs in other countries, access seekers may, as an alternative to full LLU or high speed UBS, utilise a line sharing option now, with its triple-play functionality. This appears to be a major change since the Commission's Report. The option can be the subject of Schedule 3 review or legislative intervention.
11. Of significance is that the Commission, in the recent TelstraClear determination, ended up with a final UBS determination which had the effect, out of the options available to the Commission, of going virtually as far as it could to provide the best possible service (including as to service metrics and a single price), subject to the unavoidable 128kbps upstream speed.
12. It is also worth noting that local loop unbundling offers services considerably superior to those available with the current – or any other – implementation of bitstream access. The 2004 decision to provide an Internet-grade service, specifically designed to not allow real time access, was a decision based on the Commission's extensive modelling, cost benefit analysis and submissions from stakeholders of the effects on investment (among other things) should further

8

<http://www.comcom.govt.nz//IndustryRegulation/Telecommunications/Investigations/LocalLoopUnbundling/ContentFiles/Documents/Finalreportexecutivesummary.PDF> at Para (v)

⁹ <http://www.offta.org.uk/otaupdate20050401.htm>

¹⁰ <http://www.offta.org.uk/otaupdate20050701.htm>

¹¹ <http://www.offta.org.uk/otaupdate20051014.htm>

¹² <http://www.offta.org.uk/otaupdate20060113.htm>

¹³ Macquarie Research Equities report on Telstra Corporation, dated 9 November 2005.

¹⁴ All data in this paragraph from Macquarie Research Equities report on Telstra Corporation, dated 9 November 2005.

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unbundling proceed. While the Commission was less concerned about the impact of LLU on investment, it was highly concerned about a more unconstrained bitstream service's effect on investment – presumably because the latter would provide lower barriers to entry and thus more competition.

13. It should be remembered that in telecommunications markets, technology and market conditions do change. What was the case in 2004 – comparable experience overseas, investment plans, and so on – arguably no longer holds true. Particularly from a dynamic efficiency point of view, taking a long term perspective, the costs to the broader economy of not allowing competitive delivery of high speed services are higher than they were years ago, as applications for such services continue to develop. They will continue to multiply, and New Zealand will continue to fall further behind, if the decision not to unbundle remains in place. The tradeoffs inherent in the previous decision need to be re-assessed in light of the current situation.
14. There is a further major change in the regulatory environment since the LLU Report. That Report, in parallel with its predecessor LLU determination, carved out of contention 5 ESAs in Auckland and Wellington, on the basis that competition in those wholesale markets was not limited.¹⁵ Strikingly, 2 determinations last year, addressing similar market issues, concluded that there is a national market (in which competition is limited) and the 5 ESAs were not carved out. These are the UBS and the Private Office Networking/One Office decisions¹⁶. At Para 760 of its LLU Report the Commission noted that *“The competitiveness of the relevant markets will, however, change over time.”* While that may be so here, and it may be that the relevant markets and services are different, it is difficult to discern why there is the change, other than an evolution in the Commission's thinking. This move to national markets, away from separate regional markets, is a significant change in the regulatory landscape.

¹⁵ See Para 760 of the LLU/PDN Report

¹⁶ Commission Determinations 563 and 568

Appendix B

Undertakings between British Telecom and Ofcom

The principal features of the undertakings are as follows:

Access Services Division

The establishment of a new 'Access Services Division' by BT. This new entity will include some 30,000 BT staff and nearly all its access infrastructure and facilities, including the copper local loop, local exchanges, and associated ducts and other civil infrastructure. It will deliver a comprehensive suite of the access products on which wholesale customers rely including:

- All forms of Wholesale Line Rental (WLR);
- local loop unbundling (LLU) products incorporating both full and shared;
- fibre access products including Wholesale Ethernet Service (WES) and Partial Private Circuit access products;
- Ethernet and SDH backhaul products and sub-loops specific wholesale backhaul services which are critical to effective competition including Ethernet backhaul.

The ASD will be organised as a separate business unit with its own management structure and substantial operational independence. The management board of ASD will have a clear remit to deliver Equality of Access and will establish an annual operating plan including plans and targets for adhering to the undertakings. BT has agreed that the ASD headquarters management team staff will be moved to a separate physical location to other BT staff, and BT will develop separate operating and trading systems used by ASD from those used by other parts of BT. Remuneration will be based solely on ASD's performance. BT will develop a revised long term incentive plan (LTIP) for use within the Access Services Division as soon as reasonably practicable, which will sever the link between the triggering of an award and the performance of BT Group plc's shares.

BT has also agreed that the ASD should have its own distinctive brand (name and format to be confirmed) which reflects its operationally separate status from other BT business units.

Equivalence of Input

BT commits to deliver equivalence of input for the following products to the following timescales:

- LLU - ready for service June 2006;
- WLR on the PSTN - ready for service mid 2007, migration complete June 2010;
- WLR on ISDN2 - ready for service September 2007, migration complete end-March 2009;
- WLR on ISDN30 - ready for service December 2007, migration complete December 2009;
- IPStream - ready for service end-December 2005, migration complete end-December 2006;
- Wholesale Ethernet Service (WES), and Backhaul Ethernet Service (BES) - ready for service September 2006, migration complete March 2007.

In addition, if BT does not have WLR equivalence of input ready for service by the end of 2006, with a financial rebate to operators of 25p per month per line for any month beyond December 2006. The same financial rebate applies in the event that the June 2006 ready for service date for LLU is not met.

Obligations for other products

BT's undertakings also give commitments to resolve outstanding issues in relation to Partial Private Circuits, Carrier Pre-selection and ATM interconnection.

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Other issues of governance and compliance

The undertakings also address the question of the relationship between BT Wholesale and BT Retail, providing greater clarity on the organisational separation of governance of these business units.

BT will separate out those product management teams in BT wholesale which provide SMP services from non-SMP services. Similar remuneration and incentive changes as those within ASD will apply to the teams responsible for product management of SMP products.

The Equality of Access Board's remit will cover compliance with the undertakings across the whole waterfront of SMP products. It will have five members, three of whom will be independent, and a BT non-executive board director who will chair the EAB — providing a direct link in terms of accountability to the BT Group Board. It will have independence, resources, powers and teeth. The EAB will also have a legal duty to inform Ofcom of any non-trivial breaches of the undertakings. Any trivial breaches will be recorded in the EAB's minutes which are sent to Ofcom.

21st Century Network

BT's undertakings set out some clear principles on which BT will base its future design, procurement and roll-out decisions for the 21st Century Network. These include:

- BT to ensure that the 21CN design supports competition, by allowing other operators unbundled network access;
- BT to design the 21CN in a way which will support Equivalence of Input;
- BT's charges to reflect a network that is efficiently designed for the above purposes;
- BT to launch retail products only when equivalent wholesale products are available.

These principles are underpinned by a commitment by BT to work in a transparent and multi-lateral process with other operators and service providers to manage the transition to NGNs, and to participate in a new adjudication process for disputes that may arise.

Source:

<http://www.parliament.the-stationery-office.co.uk/pa/cm200506/cmselect/cmtrdind/598/59805.htm>

Appendix 2

Figures comparing Telecom's OSP and the BT model

Figure 2

Note: This is Telecom's Presentation Slide 33, annotated with arrows and InternetNZ comments in italics.

Operational Separation – Governance

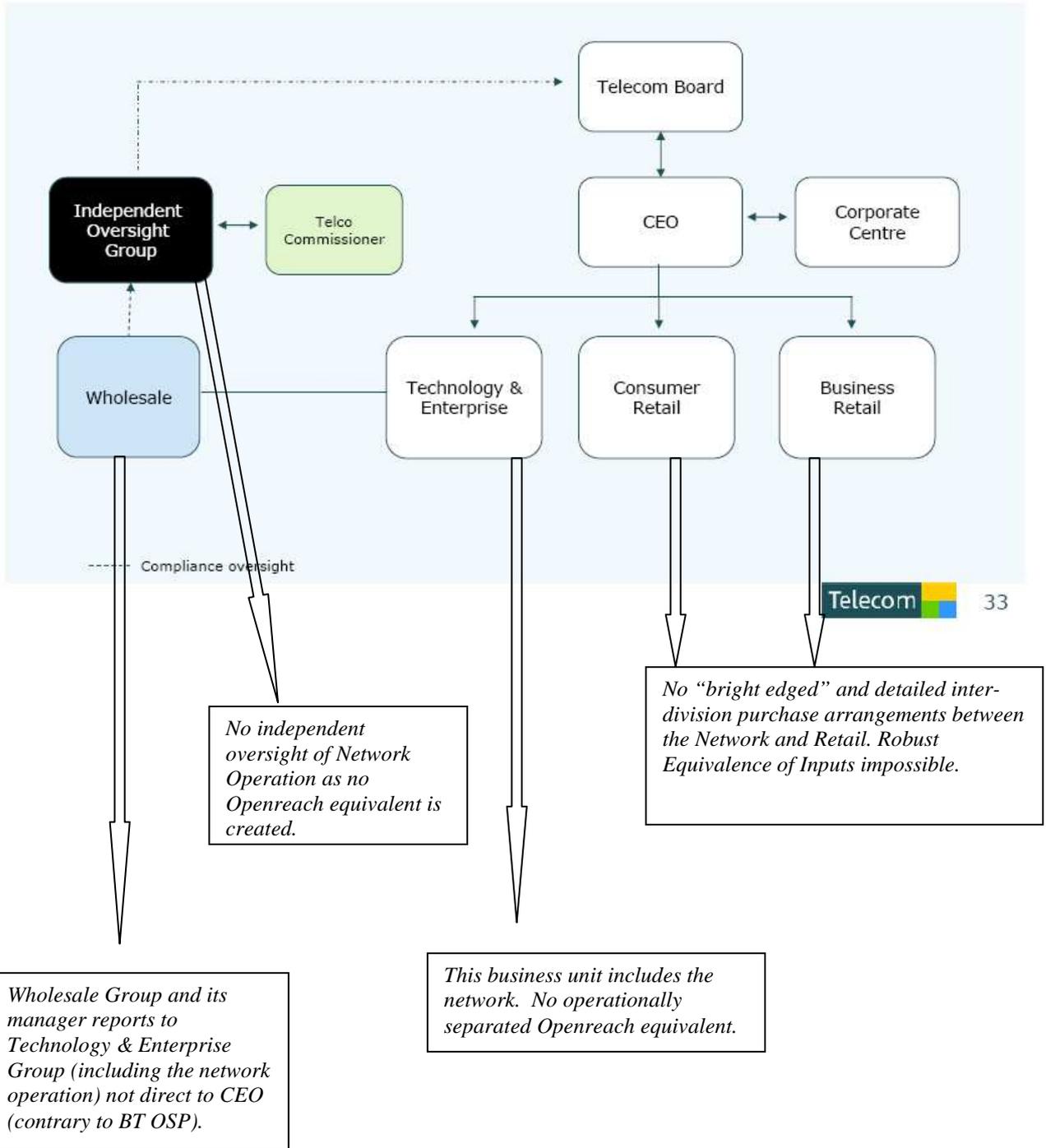
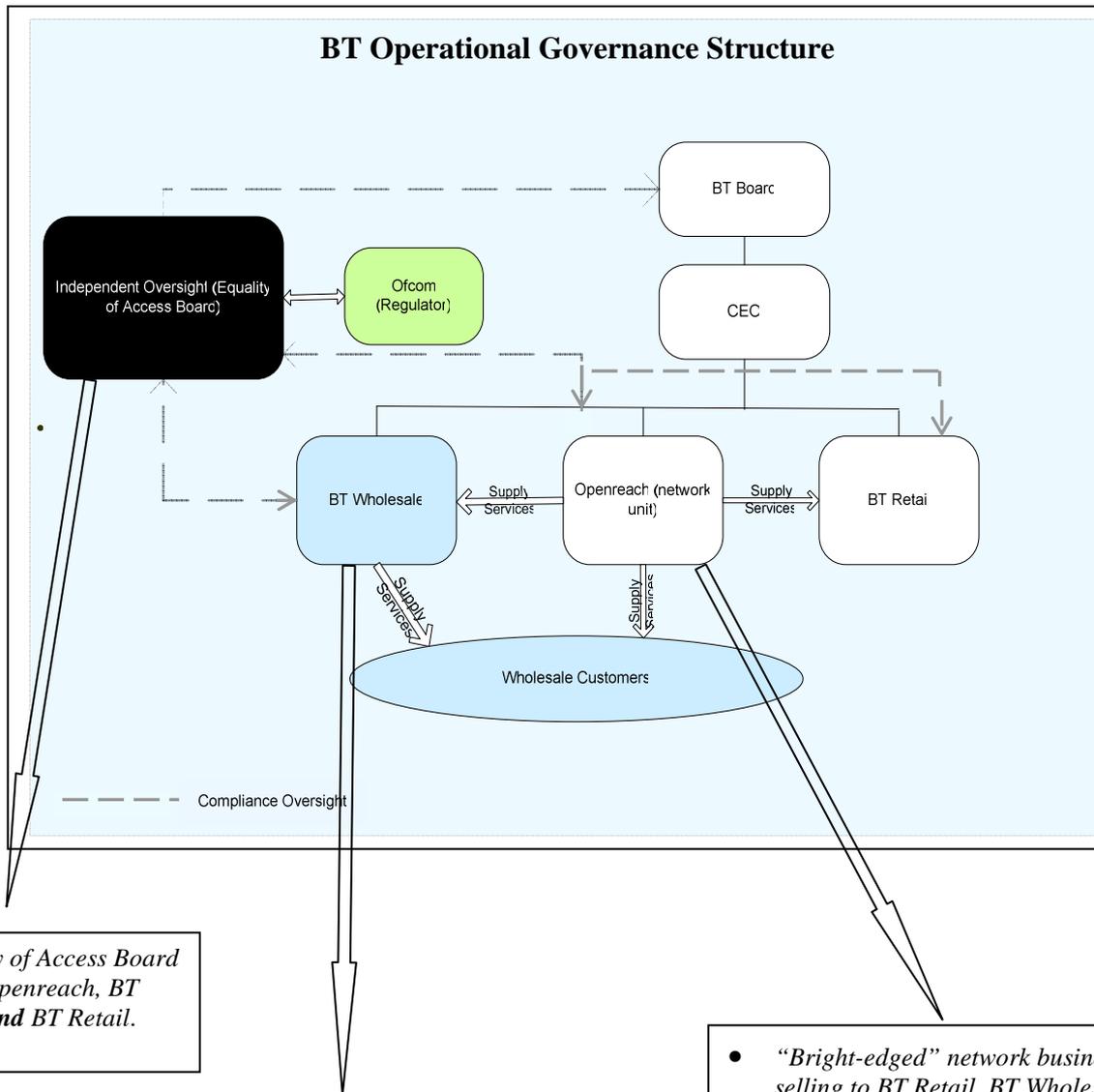


Figure 3

Note: This diagram has been prepared by InternetNZ. Compare with Figure 2.



The Equality of Access Board oversees Openreach, BT Wholesale and BT Retail.

- *Direct report to BT Group CEO.*
- *Like the Telstra OSP, BT has two operationally separated units (Openreach (network) and Wholesale), not one as proposed by Telecom (just the Wholesale Division).*
- *BT Wholesale has two relevant units (BTWS, selling regulated products and BTS, selling non-regulated products). Both units are subject to OSP non discriminatory obligations.*

- *“Bright-edged” network business unit selling to BT Retail, BT Wholesale and direct to Wholesale Customers. This enables the key outcome: equivalence of inputs.*
- *Openreach CEO cannot attend BT senior management team meetings except when Openreach is the subject matter.*

Figure 4

Similarities of BT's negotiated undertakings with Telecom's proposed undertakings

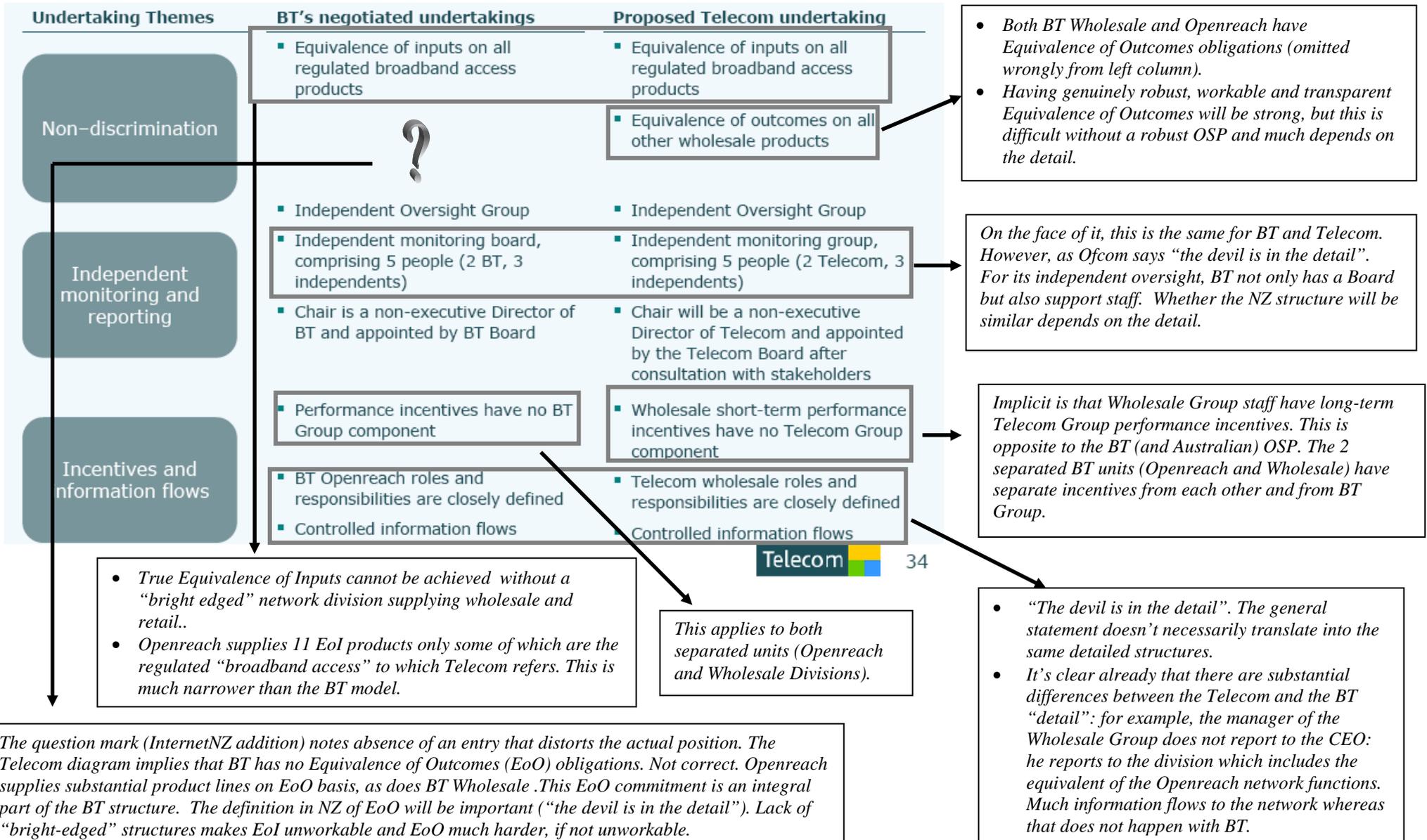


Figure 5

Note: This is Telecom's Presentation Slide 35, annotated with arrows and InternetNZ comments in italics.

Characteristics of the BT model that Telecom proposes are not relevant for NZ

BT

Two wholesale units:

- “Openreach” is the separate unit supplying regulated access products
- “Wholesale” is the unit supplying non-regulated products

Re-engineering of its legacy products to all be based on equivalence of inputs

Openreach CEO reports to the BT CEO

In the Telecom model the manager of the only separated unit (Wholesale) reports to the manager of the network group, not direct to the CEO. This is a clear indication of the diluted role that the operationally separated Telecom Wholesale Group takes.

This is a factual distortion. BT Wholesale has 2 units (BTWS and BTS) supplying regulated and non-regulated products respectively. Both units have non-discrimination obligations under the OSP. There are Chinese walls between BTWS and BTS.

THE RATIONALE

Proposal orientated around wholesale customers who generally purchase both regulated and non-regulated services (legacy services already being delivered at regulated prices)

Proposal to deliver regulated services to market as fast as possible

Like the Telstra and BT OSPs, the NZ OSP would reflect local products, etc. “Legacy” products are an issue faced in NZ too. A key driver of an OSP such as BT’s is to lead to Equivalence of Inputs and Telecom faces the same “legacy” product issue (the products may be different: the issue is the same). This is often used by incumbents as a smokescreen to avoid progress and to foster non-price discrimination, such as to common platforms (eg; common electronic OSS).

- This summary of the Telecom proposed OSP is substantially different from the BT OSP. The absence of an Openreach equivalent alone shows this. “Creation of Openreach is central to [BT] Undertakings” (BT’s Chief Counsel). But many other features are different as well.*
- This summary demonstrates that Telecom seeks little effective change in practice. The current regime has failed, and these comments largely repeat and build on the same regime. Delivery of “legacy” services at regulated prices has failed, substantially contributing to the current position. Further, the proposal is based on Telecom’s distorted view and description of the BT OSP.*

- BT OSP covers regulated **and** non-regulated services.*
- BT OSP was agreed and implemented rapidly. (Negotiated and agreed over 6-9 months and then introduced within months.)*
- While speed is important, better to get it right than to have an OSP that could be worse not better than status quo.*
- Telecom undertakings in past have been problematic and inadequate.*

*Incorrect. Openreach supplies only some of the regulated products. It supplies them to BT Retail, BT Wholesale **and** direct to Wholesale Customers. BT Wholesale also supplies regulated products.*