VODAFONE NEW ZEALAND LIMITED

SUBMISSION TO THE MINISTRY OF BUSINESS INNOVATION AND EMPLOYMENT

Review of the Telecommunications Act 2001
Discussion Document

13 September 2013

EXECUTIVE SUMMARY

Inflating wholesale copper pricing is a copper tax on consumers by stealth.

i. The Government's proposal set out in the discussion document *Review of the Telecommunications Act 2001,* means taking money from New Zealand consumers and paying it to Chorus shareholders. This intervention is quite simply a stealth copper tax on all consumers with no justification.

ii. The Government must stop this ill-conceived intervention to raise copper prices above cost. There is no evidence to suggest the UFB objectives are at risk. This proposal acts on a whim to deliver unnecessary corporate welfare to Chorus, at the expense of all consumers who will pay more for telecommunications services, including those consumers who gain nothing from UFB for a substantial period, if at all.

iii. Vodafone wholeheartedly supports the UFB initiative and the benefits it will bring. However, this narrow proposal does nothing to guarantee success of the UFB initiative. Forcing consumers to pay higher prices for copper broadband to make fibre more attractive is bad policy. Instead, the Government must focus on making UFB fibre more compelling and attractive. Meddling with copper prices does nothing to address this.

iv. Public and private investment across multiple networks and technologies will deliver faster and better broadband services – critical to driving productivity in the economy. Poorly thought out interventions that focus on a single issue and that don't consider the full range of issues will significantly undermine the longer term goals we are all working towards.

The Government must do three things

v. To best achieve better and faster broadband across New Zealand, the Government must do three things:

1. **Stop the intervention on copper prices.** Existing policy settings are correct, clear and certain. The Commission should be allowed to set copper prices as intended. Intervention to stop this is not required, and only highlights the Government's conflicted role. All three options presented will damage competition, raise prices for consumers, and do nothing to address issues that are equally important for securing a fibre future. The proposals amount to bad policy and will create more uncertainty, not less.

2. **Make fibre more attractive with significantly faster UFB.** If UFB is to be successful and transformational the Government must require all LFCs to increase the entry level service speed to 100/50Mbps at today's 30/10Mbps price. Make fibre a compelling choice. Don't make other competing technologies, in this case copper, more expensive.

3. **Provide layer 1 UFB access now to drive UFB competition.** Until 2020, UFB providers do not face competition to provide layer 2 services – an important competitive dynamic that will lead to both increased service innovation and lower fibre prices.

The proposal must be rejected

vi. Vodafone rejects the three proposals in the Discussion Document because:

- **Interfering today will not deliver UFB benefits that are ultimately transformative for New Zealanders**. It is jumping the gun by interfering barely two years into the UFB programme. The Government must address wider issues with the UFB programme to ensure that its policy goals are met. UFB speeds and prices must become more attractive. The service experience of customers purchasing and migrating to UFB fibre must be seamless, requiring greater consistency across LFCs.

- **New Zealand consumers will pay higher prices and have less choice.** New Zealanders will pay more for copper broadband services than the expert industry regulator, the Commerce Commission, has judged appropriate following an exhaustive two year investigation. The vast majority of New Zealanders will be burdened with higher copper broadband prices, without the luxury of choosing to migrate to UFB, while barely 20% of the UFB build has been completed today.

  Consumers benefit from choice between competing networks and technologies, and this is a cornerstone of New Zealand telecommunications policy. Short term Government interventions to tilt the competitive field to favour one type of technology over another; in this case, fibre over copper, is a retrograde step. It privileges a few at a cost to all, and does nothing to drive demand for new and innovative services.

- **The problem is not adequately defined, analysed or quantified.** The Government has failed to properly define the problem it intends to solve. Objective evidence is either absent or ignored. Its definition of both the problem and solutions appears based on little more than theory and anecdote, including questionable concerns about the viability of the UFB rollout programme and the financial stability of Chorus. There is no clear rationale for this unprecedented and significant intervention. The sole beneficiary is Chorus. The losers are all other players in the telecommunications industry, including LFCs, and ultimately New Zealand consumers. This is not a measure that benefits consumers, taxpayers or New Zealand; it is a measure that benefits Chorus and its shareholders.

- **Significant methodological flaws exist in the proposed approach.** The principal justification to introduce price parity between copper-based UBA and the entry level UFB service is the use of Modern Equivalent Asset (MEA). As set out in our submission, and accompanying report from consultants, Network Strategies, while MEA is a well recognised approach to pricing efficient access to monopoly infrastructure, the application of MEA analysis set out in the Discussion Document is fundamentally flawed.

- **Short term intervention to favour one company, Chorus, undermines consistent regulation of network monopolies and is unprecedented.** Chorus enjoys a monopoly on its copper network and the majority of the UFB fibre network. It is right to expect Chorus to be regulated. This is no different from other naturally occurring network monopolies in electricity, airports and gas. There is no objective justification for providing Chorus with relief from the predictable and expected results of the Commerce Commission's decisions made exactly in the manner prescribed by legislation - the very legislation that enabled Chorus' participation in the UFB project.

vii. The Government proposes to make these changes as part of its Regulatory Review under section 157AA of the Telecommunications Act 2001 (the Act). This review is intended to have a wide scope and so the Government should not opportunistically cherry pick those parts it wants, and defer looking at the wider environment to the future. We all want a stable, competitive and future-proofed telecommunications market, providing incentives to invest and innovate across all networks (not only UFB) for the long term benefit of end-users. The Government must either widen its review today to consider all these issues together, or defer the entire section 157AA review until 2016 as originally contemplated within the Act.

Introduction

1. The outcomes from the Regulatory Review must be more aspirational for New Zealanders to accelerate our digital future. Attempting to drive ad hoc changes through any of the three options proposed in the current Discussion Document moves us further away from that goal – leading to higher prices for consumers and delivering a windfall to one of the Government's UFB partners, Chorus. These options all represent bad policy.

2. A good policy outcome would involve broader discussion and genuine consideration of all aspects of the fibre market to ensure a strong, competitive and consumer-focused market. Limiting the Regulatory Review to simply focussing on the price difference between copper and fibre, but ignoring fundamental qualities and demand drivers for each is a missed opportunity. What is proposed is a poorly thought out solution to a very doubtful problem. It will not deliver the Government's vision of a fibre future, shared by all industry. It will create cost, uncertainty and loss of choice. The UFB initiative was premised on improving New Zealand's international competitiveness. We must avoid falling behind the speeds and services available in other countries such as Singapore. Delivering on this policy requires careful, evidence-based, long-term thinking – not a short term reaction to yesterday's headlines.

3. This submission is divided into two parts;

   - ***Part One: Ensuring the UFB policy delivers for New Zealanders*** sets out why the review should be broadened and the changes needed to the UFB initiative to ensure New Zealand can reap the benefits from improved broadband.

   - ***Part Two: Why the Government must not intervene in copper prices*** sets out Vodafone's concerns with the proposed options in the Discussion Document, and explains why the Government should not intervene with the existing approach to setting regulated cost-based copper prices.

PART ONE: ENSURING THE UFB POLICY DELIVERS FOR NEW ZEALANDERS

4. Vodafone recognises the transformative opportunities that improved broadband will offer New Zealanders. The move to ultra-fast broadband will be a key contributor to ensuring that "NZ Inc." has the infrastructure that it needs to succeed in the 21st century global marketplace. A consistent and principled regulatory framework is key to that objective. It must provide certainty to enable investment, competition and innovation across all networks and technologies.

Vodafone wants UFB to succeed

5. We strongly support the Government's UFB vision to:

   - Provide world class telecommunications infrastructure to increase the productivity of New Zealand's economy;
   - Improve service delivery in key areas such as health and education; and
   - Benefit New Zealanders with access to improved internet-based services using ultra fast broadband.

6. The importance of the UFB initiative to the economic progress of New Zealand is clear. For example, BERL Economics estimates that in the Auckland and Bay of Plenty regional economies alone, the productivity benefits of fast broadband could lift GDP by 7-9 percent above business-as-usual levels by 2025 if early roll-out, adoption and uptake is achieved.[1]

7. Fast broadband is the future and we support getting ultra fast broadband services to as many New Zealanders as possible. 191,000 New Zealanders can already purchase ultra fast broadband services from Vodafone via our HFC cable network, which delivers speeds to consumers of up to 130Mbps – faster than any current commercially available UFB mass market product.

8. There appears to be an assumption that unless wholesale copper pricing is artificially inflated, RSPs will not invest in or promote fibre, and this assumption is relied on to justify this intervention. This is not the case – customers will migrate to an ultra fast broadband service because of the superior benefits it brings. Just as we saw with the move from dial-up to xDSL speeds, the move to ultra-fast broadband speeds is a step change. Copper and fibre have different capabilities.

9. UFB over fibre can still remain the priority for the Government. The real question to answer is how we make fibre more attractive – not how we make a different technology less attractive via higher pricing.

The key to achieving UFB is great execution

10. The critical issue is execution - how we go about achieving the vision and policy objectives. Manipulating the wholesale pricing of one access technology to favour another is not the right way.

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[1] BERL Economics, *Regional and Inter-regional Economic Assessment of the Benefits of Broadband for the Bay of Plenty and Auckland Regions*, May 2011.

Make fibre more attractive. The UFB basic speed must be significantly faster.

11. Speeds of at least 100/50Mbps are core to the Government's UFB policy objective. Yet the current wholesale pricing model is inevitably going to drive consumers to the lower speed 30/10Mbps product – an inferior product even when compared to some copper products, such as VDSL. If customers do not see any compelling reason to migrate to fibre this will in turn threaten the Government's UFB vision and objectives.

Entry level UFB speed must be at least 100/50 at today's 30/10 price

12. Speeds of 100Mbps download must be the minimum, and the industry needs to quickly move to speeds of at least 200Mbps. LFCs are obliged to future proof their networks for much greater speeds so the incremental cost to an LFC to deliver higher speeds is insignificant.

13. In addition, the existing wholesale pricing should be reviewed. The wholesale cost of fibre in New Zealand is simply too expensive:

    - The current pricing of the 100/50Mbps product at $55 does not lead to affordable pricing for consumers. In order to deliver the policy objectives, the 100/50Mbps product should be the entry level product at the entry level price of $37.50.

    - The wholesale pricing of the two main consumer services (30/10Mbps and 100/50Mbps) is arbitrary. The current $17.50 premium for 100/50Mbps over 30/10Mbps does not reflect cost differences. Instead, the 100/50Mbps product is artificially high and subsidises the 30/10Mbps product.

    - Similarly, the pricing for some of the business services is artificially high in order to subsidise the 30/10Mbps product.

    - Our initial analysis is that the incremental cost to an LFC to supply a 100/50Mbps wholesale service versus a 30/10Mbps wholesale service is insignificant.

    - If the speeds and pricing are to remain the same, then RSPs must be given the opportunity to purchase Layer 1 services earlier than 2020.

VDSL is enjoying considerable success in the market

14. VDSL is not a stepping stone to UFB - it is a competitive alternative to entry level UFB. VDSL is a service that is easier to sell, easier to install and offers speeds comparable to, and in many cases better than the entry level 30/10Mbps fibre product.

15. It is clear from the rapid uptake of VDSL that high usage copper customers are being targeted, not only those who have long potential waits for UFB. Given the attractive returns on offer for Chorus from VDSL, the life of the copper network will be significantly prolonged at the expense of accelerating fibre uptake.

16. VDSL is simply a better alternative than the 30/10Mbps fibre product with an addressable market in excess of 800,000 homes. This fibre product is simply uncompetitive – an ugly duckling compared to VDSL.

17. The solution to this is simple – require LFCs to change the entry level UFB product to 100/50Mbps with immediate effect at the same price as today's 30/10Mbps service. This will create positive incentives for consumers to migrate to fibre for the experience – a far better outcome than simply increasing copper prices to make fibre appear relatively more attractive.

Allow RSPs to purchase dark fibre earlier than 2020

18. To ensure that New Zealanders adopt fibre so that the productivity benefits can be realised, the Government must continue to focus on ensuring its UFB partners operate as efficiently as possible. This includes introducing as much competition as possible at the lowest possible layer in the UFB network, and also focussing on simplifying and standardising processes between Chorus and the other three LFCs.

19. The current UFB programme does not allow RSPs to purchase layer 1 dark fibre earlier than 2020. Instead, access is limited to a layer 2 fibre bitstream service. The practical impact of this decision is to prevent deeper access into the network, and forego the resulting opportunities to drive efficiency and promote competition for the long term benefit of end-users.

20. New Zealand should have learnt its lesson about constraining competition to layer 2 in the copper network. Up to 2006, and in contrast to most other OECD jurisdictions, Telecom was required to wholesale a retail-minus layer two bitstream service only. In 2006, the inherent competition limitations of layer two bitstream services were recognised and the Government legislated for local loop unbundling, together with three part operational separation. Significant improvements to competition ensued, with New Zealand consumers directly benefiting from improved broadband services at lower prices as a result of competition from copper unbundling.

21. We risk repeating the mistake of constraining competition to layer 2. Competitive tension between provision of layer 1 and 2 has extracted further benefits for consumers in copper – the same is likely with fibre.

22. International best practice for similar ultra fast broadband initiatives points to the use of a three tiered market structure that applied with operational separation. For example, Singapore has adopted a three part structure with a network company, operations company and service company three-tier structure is used.

    - This allows RSPs to invest and innovate by having the choice of purchasing at the layer 1 or layer 2 levels;
    - The layer 1 wholesale price is S$15; the layer 2 wholesale price is S$6, delivering a combined wholesale price of S$21; and
    - This has allowed for very competitive retail pricing[2] which in turn has driven uptake of more than 30% over a relatively short period of time.[3]

[2] RRP starts at SN$39 per month
[3] http://www.opennet.com.sg/category/press/

23. In New Zealand, the sooner RSPs can have access to layer 1 services, the greater the level of investment and innovation that can take place, resulting in higher speeds, cheaper prices and new services.

Standardise UFB terms across all LFCs to drive uptake

24. The structure of the UFB initiative was created via a competitive tender process which resulted in the structural separation of Telecom. While structural separation was achieved, the desired outcomes have not been.

25. In particular, with the existence of Chorus and three LFCs, retail service providers have ended up with four different offers, approaches, IT stacks, networks, operational and technical processes. The result is that uptake and the customer experience will be compromised, due to inefficiencies and increased costs and complexity.

26. As an industry, we need to drive to the lowest cost of delivery to consumers, which means finding different ways of doing things. The following needs to change:

- A greater degree of co-ordination between LFCs in line with the LFC obligation to the Crown to operate in a "nationally consistent manner";
- A single approach to the points of demarcation into homes and businesses, including distances into homes and where the LFC service stops;
- One set of wholesale prices; and
- To the greatest degree possible, a tightly integrated IT approach to enable RSPs to leverage consistent processes across all LFCs, delivering a common customer experience nationwide.

Permanently address the connection challenge

27. The costs related to connecting to and using UFB services are likely to reduce the initial uptake of these services for both consumers and SMEs. Connection costs have been partially addressed with an agreement between Crown Fibre Holdings and UFB providers Chorus, Enable and Northpower to provide free residential connections for distances of up to 200 metres per house from the road, until at least the end of 2015.[4] However, this does not provide long term certainty around connections.

Benchmark the UFB programme for international competitiveness

28. A key driver for the Government is to improve our international competitiveness – particularly through enhancements to New Zealand's ability to overcome the constraints of difference and promote 'weightless' services. Internationally competitive broadband infrastructure is essential to achieving this. Is the existing level of investment sufficient and will it deliver outcomes seen internationally?

[4] Minister of Communications and IT Media release, *Free ultra-fast broadband connections*, 1 November 2012

29. The New Zealand Government is providing funding of $1.35bn over a 10 year period. For similar Government-led initiatives overseas, in Singapore, for example, the Government has granted S$1bn and in Australia the Government has committed to contribute AU$43bn. The $1.35bn being invested by the New Zealand Government, is essentially a loan.

30. At first glance, the level of direct Government investment by New Zealand does not compare well to other similar initiatives overseas. If a deficiency in Government funding is identified as the 'problem' then options for its solution should include additional funding, or converting the UFB $1.35bn loan into real money as is the case in Australia and Singapore. Alternatively, if copper prices are to be kept high, then the excess above the benchmarked amount should be put into a fund to drive fibre uptake – instead of being handed to Chorus to spend or pay out as dividends.

Open up the books instead of asking New Zealanders to blindly accept a problem

31. The apparent basis for early intervention is a view the UFB policy objectives are unlikely to be met. Without having access to financial information (if any) supporting this view, there is no transparency or ability for parties affected by the solution to verify the problem. This leaves these parties to accept on faith that a problem exists.

32. The Government proposes to intervene with little hard data, despite the significant impact on consumers. In contrast, the electricity industry has significant Information Disclosure obligations under Part 4 of the Commerce Act. Any requests to change prices must be based on factual data, not manufactured alarm. For example, Orion, an electricity lines company has sought approval from the Commission to increase electricity line charges in Christchurch to fund an upgrade to its infrastructure post the earthquake. This requires that Orion demonstrates the specific impact in order to gain approval. In contrast, the Discussion Document does not refer to any factual evidence supplied by Chorus, with the Government seemingly prepared to rubberstamp increased copper prices based on anecdote or intuition.

33. The UFB will create a fibre monopoly in many parts of the country, executed using significant public funding. As monopolies, an information disclosure framework must be put in place with LFCs, similar to the situation that exists today with electricity lines companies. This would ensure a clear and transparent approach to any changes in either funding or wholesale prices.

34. If Chorus or LFC funding is an issue the Government needs to address (which we doubt is the case today), clear and transparent financial information must be provided and verified. Only at that time is it right to consider whether additional funding is appropriate or necessary.

PART TWO: WHY THE GOVERNMENT MUST NOT INTERVENE ON COPPER PRICES

35. The Government has not sufficiently justified its proposed options for intervention. It has not properly defined or demonstrated the existence of the problem it claims to be solving. As a result, it cannot show that the actions proposed will address this problem or do so in a way that is proportionate. The Government should take no action at this time, and instead undertake a wider and more carefully considered review.

The UFB is ahead of schedule with no indication of clouds on the horizon

36. There is no problem. There is no public information to suggest that the UFB is not on schedule, not meeting current targets, or at risk of not meeting longer term roll-out UFB milestones. To the contrary:

- In August 2013, the Minister released the year two report showing that the target for UFB had been exceeded. Over the last quarter customers signing up to a service under the UFB had jumped by 95 per cent. The UFB project is in line with projections and consistent with overseas experience and the introduction of other new technologies in New Zealand.[5]

- In its 2013 Annual Report, Chorus indicated that the UFB project is ahead of schedule. [6] There has been no indication from Chorus that the current UFB build programme schedule is at risk of either delay or non-completion.

37. Announcing the Government's decision to bring forward the Regulatory Review, the Minister indicated that increased certainty around the transition path from copper to fibre would promote development of retail fibre products.[7]

38. It is not clear how the proposed intervention to increase copper prices would address this concern, or indeed whether it is a legitimate concern given that the UFB project is ahead of schedule.

Incorrect assumptions in Chorus' UFB business case should not be borne by RSPs or Consumers

39. There has been much focus on the claimed impact to Chorus' financial position of changes to copper pricing scheduled to take effect from December 2014. We have not seen any evidence which demonstrates that the impact claimed will actually occur, or of the size of this impact. We note the various observations that have been made about changes in Chorus' share price, but this tells us nothing about the financial impact and is not valid objective evidence of the 'problem' that Government is seeking to solve. Of course, if Government has real evidence relating to the impact on Chorus of the Commission's proposed change to copper prices then we would welcome its disclosure.

[5] Minister of Communications and IT, Media Release, *UFB and RBI programmes exceed year two targets*, 8 August 2013
[6] Chorus Annual Report 2013
[7] Minister of Communications and IT, Media Release, *Review to provide certainty to consumers, industry*, 8 February 2013

40. Chorus made a specific commercial decision to participate in the UFB. We expect that, as for any commercial agreement, Chorus would have carefully considered risks and rewards, and assessed risks around cost of network build, expected demand for services, legal and regulatory obligations, and the reality of competition from other networks (including copper). Chorus (then Telecom) participated in a competitive bid process and knew (or should have known) that a reduction in copper pricing over time was a possibility with a movement from retail-minus to cost-based UBA pricing, specified in the Telecommunications Act.

41. As the UFB build has progressed, some assumptions have changed. For example, installation costs have been revisited, and Chorus' estimate of its total build cost has increased by $300m from $1.4 - $1.6b to $1.7 – $1.9b.[8]

42. However, if any incorrect commercial assumptions were made, this is not a valid basis for a significant intervention that ultimately results in consumers paying higher prices. The Government's proposal is, in effect, requiring that consumers insure Chorus against any downside risk to its participation in the UFB project, in addition to the substantial benefits it has already obtained from taxpayers with interest free loans. Why should a commercial entity be further compensated by the rest of the industry and consumers because it got it wrong?

The proposed intervention fails Treasury's best practice regulation guidelines

43. The proposed options have all of the features of bad policy. They are directed at solving a poorly defined and doubtful 'problem'. There is no objective evidence of the existence of this problem or its size. There is, therefore, no prospect of the options delivering solutions that are proportionate to the problem they purport to solve. The very significant risk that this kind of intervention will lead to unintended consequences is not considered in the Discussion Document.

44. This proposal fails at a basic level on Treasury's best practice principles for regulatory design and implementation. The lack of analysis fails on Principle Two: *Proportionality*, which requires that a risk-based, cost-benefit framework is in place for both rule-making and enforcement, and that there is an empirical foundation to regulatory judgements. Such analysis is conspicuously absent from the Discussion Document.

45. The Government has placed significant weight on providing certainty. Principle Four: *Certainty and Predictability*, requires that decision-making criteria are clear and provide certainty of process. This principle acknowledges that predictability of regulatory regimes is important for firms making long-term investment decisions. The Government's proposal purports to deliver certainty on copper and fibre pricing in the short term, at a significant cost to competition and resulting in higher costs to consumers. It does so by subverting an existing and well-understood regulatory process, apparently because the Government is unhappy with the Commission's application of the framework that it established itself at the outset of the UFB project. In reality, the proposals represent a model of 'single case' intervention that is entirely at odds with any plausible understanding of certainty and predictability.

[8] Refer to NZHerald, *Chorus raises forecast UFB cost by $300m*, 25 Feb 2013.

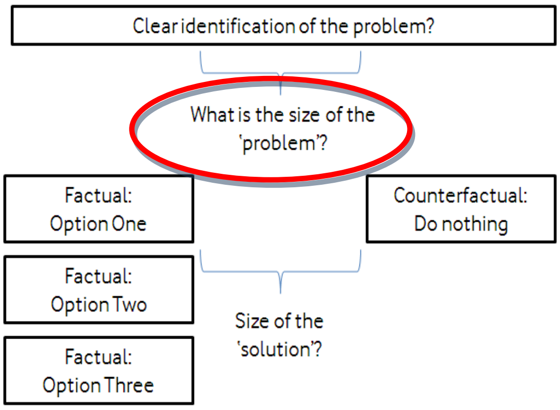
46. We disagree that the regulatory framework is unclear. Specific changes to the Telecommunications Act were made in 2011. The fact that one party does not like an outcome resulting from the framework is not sufficient grounds for introducing new uncertainty. The industry needs a consistent set of rules to apply over the long term. The present proposal in fact increases uncertainty by raising the perception that goal posts will move again if the Government decides further intervention is required to favour UFB fibre over other technologies.

The size of the problem (if any) has not been quantified

47. All three options would increase the copper price and increase Chorus revenue. No analysis has been undertaken to assess the additional revenue required to 'make good' any problem. This is particularly important where the costs will be borne by the consumer.

48. Such analysis is critical to demonstrate and allow robust, informed debate that the proposed policy intervention will achieve the policy outcomes expected. The Government's chief science advisor, Sir Peter Gluckman, in a recent report on the role of evidence in policy formation and implementation, reported a highly variable approach to the use of scientifically rigorous evidence in recommending, implementing and assessing the impacts of new public policy.[9] This proposal is a case in point.

49. The scale of any issue can only be considered by assessing the factual (the status quo with no intervention) against the counterfactuals (the three proposals in the Discussion Document). This has not been completed. The Government has swept aside the Commission and dispensed with a cost-benefit analysis – a standard tool of quality, robust and transparent decision-making.



50. Various analysts have assessed the impact on Chorus of the change from retail-minus to cost-based pricing from December 2014. But is this impact illusory?

Analyst reports are not grounds for intervention

51. The Commerce Commission's UCLL and UBA processes have, over a detailed multi-year investigation, generated the best estimate of Chorus' efficient costs of proving copper services in New Zealand. An implicit element of the analysts' views is that the Commission's assessment is

[9] Refer to NBR article, *Too much instinct, too little evidence in policy-making, says Gluckman*, 3 September, 2013.

'wrong', but they offer no alternative analysis to support their views beyond a general concern that prices are 'just too low'. Effectively, what they are saying is that Chorus should be entitled to charge prices that are well in excess of its efficient cost, and anything that denies it this ability is a harmful financial impact.

The Commission's draft decision is just that – a draft.

52. The Commission's draft decision on the cost-based UBA price concluded a benchmark of $8.93. The Commission's approach and conclusions are consistent with its duties under the Act. This draft benchmark is also in line with the costs faced by other telecommunications companies that provide broadband over unbundled copper local loops.

53. All parties also have the option to seek a review of a price set by the Commission. This would require that the Commission specifically models Chorus' costs to supply UBA on a TSLRIC (Total Service Long Run Incremental Cost) basis, so any concern that the internationally benchmarked price was below cost is capable of full remedy.

54. It is unclear as to whether the Government's proposed intervention has influenced or impacted the Commission's work. If the Commission's final decision, expected at the end of October 2013, is materially higher, does this invalidate concerns about the size of the problem?

The analysis ignores competitive tension.

55. There appears to be a belief that Chorus could sustain today's high UBA price into the future, and that competitive tensions would not ultimately erode the above-cost UBA price. We believe this assumption is unrealistic for a number of reasons:

- UBA prices are likely to fall over time: Above-cost UBA prices would provide incentives for further unbundling to occur – from both existing unbundlers and also by Telecom after December 2014. Chorus would face a choice – lose UBA revenue as RSPs move to purchase UCLL instead – with lower margins and revenue loss, or reduce UBA prices. We believe that Chorus would have strong incentives to reduce UBA prices (particularly with the threat of Telecom unbundling) to maintain higher bitstream revenue rather than allowing significant movement to UCLL.

- Substitution to competing technologies will occur: Chorus will face competition from other technologies and networks. This includes migration to mobile broadband (such as substitution to 4G data), RBI fixed wireless broadband in rural areas, competing fibre networks (including UFB in areas outside Chorus' UFB footprint) and Vodafone's HFC cable networks. We would expect competitive downward pressure on UBA pricing as a result of competing networks.

- Cannibalisation from its own UFB network: Customers migrating from copper to fibre will reduce Chorus' UBA and UCLL revenue. Chorus has a specific long term target of 20% uptake by 2020 to avoid contractual penalties. However, there are no specific migration targets or expectations. The UFB programme does not have any migration obligations from copper to fibre. In contrast to Australia, forced migration from copper to fibre is not a part of the UFB programme, but instead will occur through consumer choice. Without migration requirements, Chorus has flexibility in the speed of migration from one technology to another.

The analysis ignores whether UFB funding is sufficient.

56. Chorus will rely on copper revenues to fund its UFB build, which we assume was built into Chorus' UFB business case. As a UFB participant, Chorus is in a unique position in having nearly 95%[10] of the fixed broadband customers on its copper network. In contrast, on bidding, the other LFCs' business cases would have required that their UFB network build and uptake assumptions were viable on a stand-alone basis. We question whether an expectation of cross subsidy from its copper network is either appropriate or necessary. In bringing forward the Regulatory Review (and putting forward the current proposed solutions), the Government has focussed solely on changes to the UBA price. It appears to have ignored other changes to costs, such as Chorus' own estimates of costs to build the UFB network have increased by $300m. As discussed, we simply don't agree that such changes should be met by consumers.

The analysis ignores other options to address any funding concerns.

57. Significant sections of the Chorus Network Infrastructure Project Agreement ('NIPA') with CFH are redacted. Two specific clauses not redacted that allow renegotiation between CFH and Chorus are clause 11.3 relating to regulatory events, and clause 11.4 relating to extraordinary costs.

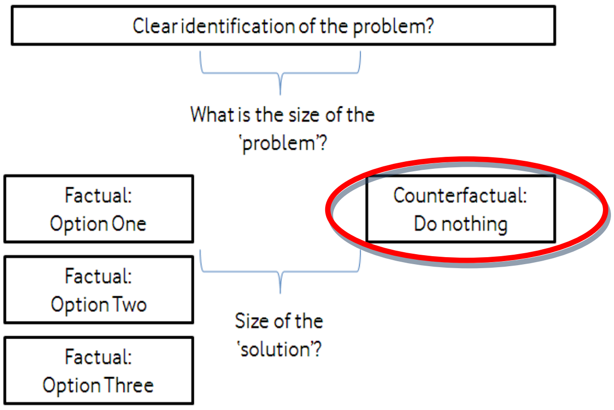
58. It is unclear whether there are other contractual provisions within the NIPA that may address any funding concerns, and whether such funding issues can be addressed specifically within the agreement between the Crown and Chorus. In any case, funding issues should be addressed within the remit of the Crown/Chorus contract, rather than increasing the price of copper broadband.

Short term changes to share prices are not a basis for making long term decisions.

59. Much has been made about the impact on Chorus' share price following the Commission's draft UBA price, and what analysts and Chorus say 'surprised' the market. Relying only on short term observations of Chorus' share price to conclude that significant telecommunications policy changes should be made, without any further analysis and comparison with general sharemarket movements, movements in regulated asset classes or specific movement of Chorus stock over time, is flawed.

[10] From Chorus 2013 Annual Report, Chorus has 94.6% of the fixed line market in New Zealand, with Chorus fixed lines of 1.78m, and total fixed lines in New Zealand of 1.88m.

The option of doing nothing has not been considered



60. Headline figures and impacts on Chorus have been bandied around. As discussed above, and without further analysis, limited weight can be placed on those figures.

- No analysis has been undertaken on the impact of higher broadband prices (against the counterfactual) and potential impact on usage.
- No analysis has been undertaken of the impact on RSPs who have invested in unbundling the copper local loop. The importance for unbundling to drive competition is recognised by the Commission. The Government itself recognised the value of local loop unbundling in its decision to specifically regulate for both UCLL and UBA in 2006.
- No analysis has been undertaken of the impact on other LFCs of changes to Chorus UFB copper prices.
- No analysis has been undertaken of the impact on the incentives of other participants in the telecommunications industry to invest in new and innovative services following the proposed intervention.

61. More comprehensive analysis needs to be undertaken by MBIE to accurately define the problem and any proportionate solution to it. Instead, MBIE appears to have moved to a 'solution' mode to an undefined problem – despite its substantial negative impact on consumers.

62. Without proper analysis, and consideration of the issues raised above, all three proposals will:

- Increase broadband prices for consumers from December 2014;
- Penalise copper broadband users to fund Chorus; and
- Be likely to overcompensate Chorus for an unquantified gap.

The proposed solutions and underlying assumptions are flawed

63. Vodafone commissioned Network Strategies to review the proposals. Network Strategies' report is attached to this submission. This report identifies significant deficiencies with the Discussion Document approach and rationale, and recommends that the Government maintain the existing structure and pricing method for both UCLL and UBA; namely cost-based pricing set by the Commission.

64. Network Strategies conclude that as a general principle, access prices should be cost-based and reflect the forward-looking cost of efficient service provision. This principle is consistently applied today as international regulatory best practice for copper wholesale pricing. It provides appropriate price signals to the market, thereby avoiding market distortion and promoting competition to the benefit of end-users.

Raw adoption of MEA is inappropriate

65. Network Strategies also conclude that fibre cannot be seamlessly swapped for copper as the MEA in New Zealand. The MEA approach proposed is problematic, and would require significant adjustment because:

- Investment in copper infrastructure is still occurring, particularly for VDSL services;
- The GPON network architecture does not deliver physical services that are equivalent to an unbundled copper service;
- Fibre is only available on a limited geographic basis so cannot serve as a ubiquitous MEA, even when fibre deployment is complete;
- Given the early stage of fibre deployment, there is still considerable uncertainty regarding the costs while demand remains low; and
- Many characteristics of fibre (costs, network performance) differ substantially from copper, meaning that to achieve 'equivalence' with copper it is necessary to consider introducing adjustments to the analysis. There is no consensus regarding an appropriate approach for this as few regulators have attempted implementation of a fibre MEA.

66. Network Strategies identify two countries (Sweden and Denmark) where regulators have chosen to adopt a MEA approach to price copper networks. Importantly, these are the same two countries relied on by the Commission in its UBA draft determination – the same two data points that appeared to triggered the decision to intervene and set copper prices above cost.

67. Network Strategies questions whether copper prices based on MEA are appropriate, and accords with an essential principle that MEA should produce efficient prices that are:

> *...not too low that they discourage investment and innovation by telecommunications companies in modern replacement networks, but no higher than they need to be, so that consumers benefit from falling costs over time.*[11]

[11] European Commission (2012) *Commission Recommendation on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment,* December 2012.

The selection of the UFB price point is arbitrary

68. The Discussion Document proposes to set the UBA copper price to align with the entry level 30/10Mbps service that is currently priced at $37.50 and increasing to $42.50 by 2020. UFB wholesale prices represent the outcome of a commercial negotiation between Crown Fibre Holdings and LFCs. Network Strategies conclude that the wholesale prices within the agreement were not cost-based, but aligned with a price point that was selected as appropriate by CFH.

> *If the UFB wholesale prices are not cost-based, and we tie copper wholesale prices to UFB wholesale prices, then it is clear that in doing so we are departing from the cost-based standard which we have applied in New Zealand since 2001.*[12]

69. Aligning the copper price to the 30/10 Mbps by justifying on the basis of MEA is accordingly flawed, and should be rejected.

Tying copper prices to UFB will compound challenges with price setting

70. Not only is this a problem today, the problem will be compounded when the approach to regulated fibre pricing must be considered post 2020. At this point, commercial pricing arrangements between the Crown, Chorus and LFCs end. Instead, prices will have to be set with reference to an appropriate measure of Chorus' efficient costs.

71. As Network Strategies identifies, a significant risk then exists that, in 2020, Chorus will present a case to Government that the UFB contracted prices were not cost-based, that it is unable to obtain a fair return on its investment, and consequently that wholesale fibre prices should either be unregulated or if regulated must increase substantially from current levels. Having copper prices tied to fibre prices at this point could then lead to even greater potential increases in copper prices for broadband.

Affordability of broadband will constrain growth

72. Network Strategies identify the real risk that, given the Government's proposed approaches to price regulation by departing from cost-based pricing, is likely to constrain the overall broadband market in New Zealand when compared with other countries. Given that the UFB rollout is not expected to be completed until 2019, with copper prices under two of the options able to be implemented from the end of 2014, many end customers over this five-year period are likely to face higher copper pricing and no fibre alternative.

> *Therefore the Government's options on copper pricing have the potential for constraining the New Zealand fixed broadband (fibre plus copper) market – perhaps stalling growth in demand or at worst creating a decline in fixed broadband subscriptions, if customers switch to mobile broadband.*[13]

[12] Network Strategies, *Review of the Telecommunications Act 2001, Key Issues*, 13 September 2013.
[13] ibid

The proposed approach is unsound and may breach our international obligations

73. The phased approach set out in the Discussion Document causes us significant concern.

74. In our view, the Minister is directed by Parliament to consider the effectiveness of the current regulatory framework in a single and comprehensive review of how effectively it delivers all of the specific outcomes listed in section 157AA(2)(a). However, the Discussion Document only considers "...*whether the current regulatory framework is fit-for-purpose for the transition from the legacy copper network to the new fibre network",* [14] which in effect refers to the single outcome referred to in section 157AA (2)(a)(iii). Consideration of other factors that must be taken into account is deferred and legislative change to the current regulatory framework as proposed is based on a much narrower consideration than contemplated by statute.

75. In addition, the nature of the factors that must be considered under section 157AA mean it is difficult to properly consider any single issue in isolation. This provision envisages the contemporaneous consideration of interrelated issues. Assessments made on one issue may well affect those made in respect of other issues. For example, when considering the effectiveness of the existing regulatory framework with reference to section 157AA(2)(a) outcomes, it will be difficult to divorce thinking about how well this promotes competition from how well it encourages efficient investment. In this sense, the phased approach is inconsistent with sound policymaking, in addition to being inconsistent with the terms of the statute.

76. It is also important to remember that a UBA Determination of the kind since made by the Commission was envisaged by Parliament as something which might well occur prior to the 2016 commencement and the 2019 conclusion of the section 157AA review process. If Parliament had meant the review process to be used in effect to override a UBA Determination by the Commission, then one would expect that to have been clearly provided for in section 157AA of the Telecommunications Act. That is not the case.

77. Finally, we are concerned that the Discussion Document nowhere addresses the extent to which proposed Options 1-3 are consistent with New Zealand's international law obligations.[15] In particular:

   a. Each of the options proposed in the Discussion Document would result in the price for Chorus' UCLL and UBA inputs, both necessary for interconnection, being set in excess of cost based prices that are ordinarily understood to provide non-discriminatory price terms. In addition, the implementation of these options would deprive parties of the ability to ask the Commission to address disputes regarding appropriate terms, conditions and rates. There would apparently be no provision for the Commission to make any adjustment to settings imposed by Government under these options. We doubt this is consistent with paragraph 2 of the GATS Reference Paper.

[14] See Discussion Document, §60.

[15] Specifically, those obligations in the WTO General Agreement on Trade in Services ('GATS'), its Annex on Telecommunications ('the Annex') and the Reference Paper negotiated as part of the fourth protocol to the GATS ('the GATS Reference Paper'). New Zealand has adopted the obligations set out in these documents and is therefore bound by them.

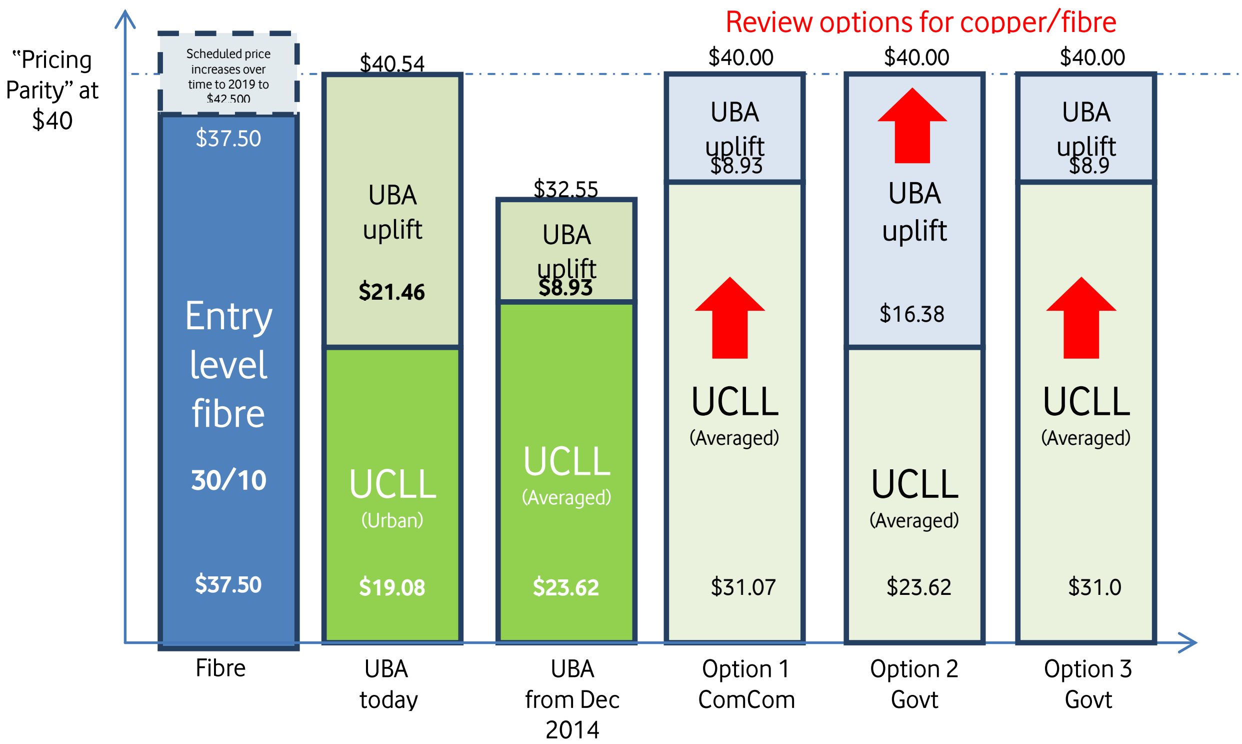
b. The Minister proposes removing a function ordinarily undertaken by the Commission and setting certain prices directly. However, the Minister clearly is accountable to a supplier of basic telecommunications services via obligations in contracts between Chorus and the Crown, and is proposing decisions that clearly favour that supplier. We doubt this is consistent with fundamental principles of independence in relation to a domestic regulatory body for telecommunications set out in paragraph 5 of the GATS Reference Paper.

MBIE's Option Two is the least damaging to competition

78. For the reasons set out in other parts of this submission, Vodafone does not support any of the three proposed approaches tabled by MBIE. They are all bad policy and Government should not intervene on this basis. Should the Government decide to push on with an approach set out in the Discussion Document, a modified Option Two would be the least damaging. To be clear, Vodafone does not support Option Two (or any option put forward). Option Two is, however, the least worst of a 'Clayton's choice'.

79. The practical impact between the three options remains unknown, because the Commission is yet to finalise the regulated cost-based UBA price. The Commission's most recent consultation suggests that, through changes to its benchmarking approach, the current draft UBA price of $8.93 may be increased, in light of guidance provided by the Commission's expert, Professor Ingo Vogelsang.

80. Using the draft UBA price, and assuming the Commission or Government determine that parity should be $40 (taking a midpoint between today's price of $37.50 and the price of $42.50 in 2019), the following changes would occur to UCLL & UBA pricing:



81. The practical impact of all three options would be to increase the UBA price from December 2014 by $7.45 or 22.89% above the TSLRIC price determined by the Commission's benchmarking across all customers. The proposed increase will affect:

a. customers who have the option to switch to fibre today if UFB is available in their area;
b. customers who have the option to switch to fibre in the future once UFB is deployed in their area; and
c. customers who will never benefit from UFB.

82. The Commission is further consulting on the draft UBA price, with indications that the final price will be higher than the draft UBA price of $8.93. Even if the Commission was to conclude that the final price should be $12 – 14, the practical impact would be an increase above cost between 6.33% and 12.30%.

83. Vodafone suspects that the independence of the Commission, and its ability to perform its statutory functions without undue political pressure, has been compromised through this process.

Option Two is the least damaging to competition

84. Option Two in the Discussion Document is that the Government sets the UBA price in the range between $37.50 and $42.50 to be the same as the entry level service, maintain the existing averaged UCLL price of $23.62, with an adjustment to the UBA price to total the set UBA price.

a. Unbundling competition would partially remain

Amendments to the Act in 2006 introduced unbundling, allowing access seekers to further ascend the ladder of investment, and self serve at a level below bitstream. While the introduction of this model was significantly later than in most other OECD countries, it is clearly recognised that retail broadband competition has thrived in New Zealand as a result of the competitive tension and differentiation available through unbundling.

- Options 1 and 3 create a significant risk that unbundling becomes unviable, resulting in the stranding of existing unbundling investments of access seekers, and removing incentives for further unbundling or innovation on copper to occur.

- The 2011 amendments to the Act specifically allow Telecom to unbundle exchanges three years after structural separation in December 2014. We believe this is an important dynamic that must be retained.

- The option of unbundling at cabinets (subloop unbundling) must be maintained. The cabinetisation programme has resulted in nearly half of broadband lines being fed from local cabinets. The economics of subloop unbundling are challenging for existing RSPs. We believe retaining the ability to unbundle from cabinets is essential to retaining competitive pressure on Chorus – particularly as Telecom considers unbundling after 2014. The proposal to remove subloop unbundling specifically is arbitrary and without justification.

b. Incentives for Chorus to compete with UBA pricing would remain

Setting a UCLL price above cost under options 1 and 3 reduces the incentive for Chorus to compete to provide UBA services to Retail Service Providers (RSPs) including Telecom, rather than unbundled services. All RSPs would benefit from reduced UBA services because of non-discrimination requirements.

Under options 1 and 3, Chorus would simply 'bank' any increase to UCLL price above its cost, with little competitive tension to reduce UBA prices over time.

This competitive dynamic was always in play when Chorus decided to participate in the UFB project. In the absence of Chorus being willing to reduce UBA prices under the regime, Chorus would have faced lower UBA pricing anyway or faced a significant reduction in its copper revenues as Telecom unbundled its exchanges (and potentially undertook subloop unbundling too).

Analysts and Chorus appear to hold false assumptions that, if the Commission had found that a movement from retail-minus UBA to a cost-based UBA price resulted in no change to the UBA price, Chorus would be able to somehow competitively sustain that. This is convenient naivety in the extreme. This also fails to ignore ongoing competitive pressure from mobile substitution, and other competing fixed fibre and cable networks.

In all cases, the Commission should be responsible for setting the price

85. Option Two proposes that the Government legislates for the specific parity price that should apply for UBA. Vodafone believes that the Commerce Commission is best placed to set the price for several reasons:

    a. **Maintaining the independence of the Regulator is essential**: An independent regulator is important and consistent with regulatory best practice principles.

    b. **Managing price changes over time:** Setting a price in statute assumes that the issue and price will be set for all time. In competitive markets, it is essential that prices can adjust over time. The Commission has the tools and expertise to consider any future changes through its statutory role.

    c. **Maintaining consistency across all regulated infrastructure:** The Commission is responsible for the regulation of a number of regulated infrastructure industries, including telecommunications, electricity, gas and airports. A consistent approach to regulation of infrastructure industries, especially in monopoly markets, including a consistent approach to balancing dynamic and static efficiencies, is important.

Should Option Two only apply where and when UFB is actually available?

86. All three options will impose increased costs on end-users who do not have today, or may never have, the option to purchase UFB fibre. The potential migration benefits would not be practically realised. Instead, customers outside the UFB footprint would be forced to pay higher prices to fund and incentivise migration to UFB fibre of urban subscribers. This is discriminatory against rural broadband users. One option to address this would be for any increase in copper prices to apply only as UFB is progressively made available over time. We encourage MBIE to put more thought into this and we would be happy to contribute our ideas.

CONCLUSION

87. The Regulatory Review offers a real opportunity to create a certain and sustainable regulatory environment. All three options presented will damage competition, raise prices for consumers, and do nothing to address issues that are equally important for securing a fibre future. The proposals amount to bad policy and will create more uncertainty, not less.

88. The Regulatory Review is intended to have a much broader and ambitious scope and so the Government should not opportunistically cherry pick those parts it wants, and defer thinking of others.

89. We support any proposal made in the context of a review that addresses the full range of issues necessary to secure a fibre future that delivers real benefits to consumers. If Government had instead proposed a solution in this form, which addresses the drivers of demand identified early on, any benefits of fixing copper prices in return for delivering such wider and clear benefits to consumers may have been considered differently. But we cannot support the current proposals, which are too narrow, do not deliver the transformative capability that higher speed UFB services can provide, and simply result in higher prices to consumers.

90. To achieve and faster broadband across New Zealand, the Government must do three things:

    a. Stop the intervention on copper prices;

    b. Make fibre more attractive with significantly faster UFB; and

    c. Provide layer 1 UFB access now to drive UFB competition.

91. The three proposals set out in the Discussion Document must be rejected:

    a. Interfering today will not deliver UFB benefits that are ultimately transformative for New Zealanders;

    b. New Zealand consumers will pay higher prices and have less choice;

    c. The problem is not adequately defined, analysed or quantified;

    d. Significant methodological flaws exist in the proposed approach; and

    e. Unprecedented intervention to favour one company, Chorus, undermines consistent regulation of network monopolies.