Telecom High Level Proposal in response to MED April 2007 Operational Separation Consultation Document

Introduction

The Government has previously stated its Digital Strategy objectives:

- *60% of residential and SME customers have fast (>5 Megabits/second) broadband on demand by 2007.*
- *90% of residential and SME customers have fast (>5 Megabits/second) broadband on demand by 2010.*

Translated, the Government wants:

- More effective competition
- New products and better customer experience
- Investment in the sector.

Telecom is concerned that the shortcomings of the current operational separation process that we have identified (refer to the accompanying Impact Analysis), combined with the absence of linkages to Commerce Commission and TSO processes will seriously undermine the ability of the sector to attain the Digital Strategy objectives.

Telecom is not proposing to relitigate existing policy settings or legislation. Indeed this proposal would still require the other elements of operational separation, albeit we think our proposal would mean much complexity could be removed. Telecom expects to continue to work within the existing framework and have our views tested with industry groups and with officials.

Core concerns with the current processes are set out later in this paper. First, we set out the key elements of Telecom's proposed path forward and why we think that will produce better outcomes for New Zealand.

Proposal

Our proposal will deliver:

- A level playing field for access seekers and faster delivery of new products
- Strong incentives for long term investment in infrastructure

- A future-proofed broadband network that is consistent with the Digital Strategy objectives.

We see six essential elements that are all integral to a better industry solution:

Creation of a Sustainable, Future-Proofed Netco

Creation of a structurally separated sustainable 'Netco' that owns the fixed bottleneck access assets and has the right capability and incentives to meet New Zealand's future needs.

This Netco would own the physical copper access assets (but not electronics). It must be able to receive an adequate (regulated) rate of return in order to provide it with the cash flow necessary to invest to meet customer demand. It would be prevented from investing upstream and re-integrating. It could also potentially be protected by regulation from network bypass if that was considered desirable to allow access cross-subsidies.

The Netco does not need to be owned by Telecom. It could be sold outright or could be folded into a partnership with industry participants and/or the Government.

Telecom expects that at least some degree of ownership separation would enhance the credibility of the model and avoid the complex governance procedures that appear to be emerging in the current process. Other elements of operational separation would still be required but could be much simpler to implement.

The model should accommodate future technology changes and likely fibre to the node ("FTTN") deployment scenarios (ie, it should be sustainable and future proof). This is important because of a looming dilemma between FTTN deployment and LLU investment by competitors.

To explain this further, Telecom wishes to make significant investment in loop shortening (also known as cabinetisation) and roll out FTTN (to the cabinet) closer to customer premises. This is required in order to deliver faster, more consistent and reliable broadband services to customers. Everyone is calling for this to occur. Conversely, as a result of doing this, our competitors who invest in LLU in exchanges early could end up with stranded assets. This creates a dilemma of priorities- broadband network improvement vs. improving competition.

We think we have found a way to address both whereby loop shortening can occur, and our competitors will be incented to invest in infrastructure (early).

Faster Delivery of LLU and Naked DSL

Under a simpler form of separation with practical forward-looking equivalence standards, Telecom and Netco could commit to the delivery of access services and regulated wholesale products on a rapid timeframe. At the moment we have real concerns about our ability to deliver these quickly given the competing priority of putting operational separation in place at the same time. [Refer to the accompanying Impact Analysis Note]

Pricing that Encourages Investment

Pricing of regulated services needs to be sufficient to support future investment in the network. Inadequate prices, or prices inconsistent with the economics of broadband, will simply result in price competition on the existing network rather than support the required investment in future network capability.

Future Deregulation

Transparent and credible access separation will allow a more rapid transition to downstream deregulation. With guaranteed ongoing equal access to Netco, competitors and Telecom will have the confidence to invest and develop their own services rather than reselling regulated Telecom services. Over time, regulated resale and bitstream services should be removed as milestones for competitor activity are met.

Specific Long-Term Investment Commitments by Telecom

A package with all the above elements and an acknowledgement that Telecom and access seekers should be able to compete on the same basis would allow Telecom to make firm investment undertakings as part of the package.

Regulatory Coordination

An essential feature of the package above is a shift to coordinated central regulation. Currently MED are working on the structure of operational separation and the Commerce Commission are separately working on pricing and regulating services. In addition the TSO review is expected shortly. These things are all linked. This has the potential to produce unintentional and perverse outcomes and certainly causes prioritisation concerns.

What's in it for New Zealand?

Telecom believes that structural separation together with the above elements will greatly enhance New Zealand's ability to achieve stated Digital Strategy objectives. The outcome would be a sustainable form of separation that is much more able to cope with future technology developments, and would avoid the need for ongoing micro-regulation.

We believe the model outlined above would point to more competition and more investment in both the short and medium term. Telecom would benefit by being able to direct its skilled IT resources at customers, including wholesale customers, rather than at regulators.

We also believe this would be consistent with the current policy thinking, would be innovative when viewed in the global context, and would avoid the likes of the apparent stalemate that is occurring in Australia in respect of these issues.

Concern With the Current Model

Our core concerns with the current situation arise from the likely interplay of four factors:

- A complex operational separation model that diverts resources
- Commerce Commission interventions on pricing
- Pending TSO review
- Future technology changes.

Complex Operational Separation

We expect the operational separation model under development will impose costs and complexity that work against customer and market outcomes. Specifically, we are concerned that the proposed model (as outlined in the MED Consultation Document) will:

- Create equivalence requirements that require very significant establishment and ongoing costs
- Seek unrealistic and unwieldy governance procedures
- Consume specialist IT resources that would otherwise be deployed in the development of enhanced services for wholesale and retail customers
- Seek delivery timeframes that are not likely to be met even with the diversion of specialist IT resources to the separation project.

Accompanying this paper is a summary impact and risk analysis prepared by our operational separation implementation team.

Commerce Commission / TSO

In our view, current and expected Commerce Commission decisions are likely to:

- Constrain the separated network unit's pricing such that there is little chance of significant future broadband investment in any but the most dense urban areas; and

- Set DSL access prices on intermediate bitstream (i.e. UBS, Naked DSL) products that will make LLU investment challenging at best. In almost all exchanges naked DSL/UBS will be preferable to LLU because of the low price set by the Commission and its low risk compared to LLU.

Further, we are concerned that the TSO review is not coordinated with the operational separation process.

Technology

We are concerned that the model will not accommodate technology changes. For example, LLU investors will not want Telecom to invest in fibre and loop shortening programmes because it will strand their assets. This will create a divergence between industry participants and Government policy demands in relation to network coverage and speed.

Investment

Our current investment plans do not accommodate extensive loop shortening/ cabinetisation. Future investment commitments are not dependent on Telecom retaining the Yellow Pages Group sale proceeds. We will have sufficient cashflow and financial flexibility to invest whenever and wherever we see returns.

Likely Outcomes of Current Approach

In summary, we expect that the current regulatory initiatives will:

- Produce a flurry of short term price competition in dense urban areas, primarily in Naked DSL/UBS products; but

    - Undermine the excellent progress the industry has made under the auspices of the TCF in defining LLU and naked DSL services over the past nine months

    - Impose high costs

    - Mitigate against significant LLU investment

    - Mitigate against investment that extends the reach and speed of the broadband network- particularly FTTN; and

    - Widen the gap between metro and rural services.

Digital Strategy Targets Will Not Be Met

The diversion of resources and lack of incentives for investment will make the 2007 (60% at 5 Megabits/second) and 2010 (90% at 5 Megabits/second) targets unachievable.

Where to from here?

Telecom believes the proposal outlined is totally consistent with the current policy settings and objectives. Indeed it goes further as it provides a sustainable solution for both competition and investment into the future and will deliver the desired outcomes.

This proposal would clearly need to be tested, particularly with the industry. Telecom is about to engage with industry to gauge their views.