

Regulatory Alert

9 February 2010

Telecommunications Regulation - A Year in Review and the Year Ahead

This Alert provides an overview of the key regulatory developments in the telecommunications sector last year, focussing on those matters that are likely to be of high priority in 2010.

Introduction

Late last year the Commerce Commission ("**Commission**") released its Telecommunications Market Monitoring report, which assessed market development and performance for the first six months of the year, ending June 2009. It also included more recent information on mobile pricing due to 2Degrees entering the market in August.

Unsurprisingly, the Commission observed that there has been "extensive investment in mobile network infrastructure".

Vodafone extended its 3G network, and Telecom completed the roll-out of its new 3G XT mobile network. 2Degrees completed the first stage roll-out of its mobile network to cover approximately 45 percent of the population.

The Commission's report found lower prices for prepaid mobile plans, largely as a result of competition from 2Degrees. For the first time in the Commission's analysis, New Zealand consumers were able to access a prepaid plan at prices lower than the OECD average. In the Commission's view, the building of technologically compatible mobile networks has also made it easier to switch between networks without changing phones, noting that in August and September there were more than triple the usual number of mobile subscribers switching to another network and taking their number with them.

Other positive findings include growth in take-up of broadband services at an annual rate of around 14 per cent (which is above the OECD average) and that the pricing of broadband services in New Zealand is broadly in line with

that of similarly developed countries.

The Commission also noted continued strong growth in the number of wholesale services sold that allow other providers to compete against Telecom in the retail market.

Although some of these promising outcomes can be directly attributed to recent regulatory intervention, at a broader level the question remains whether long term improvements in competition and quality of services to end-users will be achieved in despite of, or as a result of, the recent regulatory avalanche in the telecommunications sector. Key in this respect will be investment in new technology. What is certain is that regulatory intervention in the sector is not showing any signs of slowing down in the near future.

Government initiatives

The telecommunications regulatory whirlwind created by the previous Government has retained its force under the new Government. However, its direction has arguably changed slightly, from removing Telecom's perceived ability to exercise market power, to encouraging new investment in networks to compete with Telecom, using billions of dollars of taxpayer funds to do so.

UFB Initiative

On 16 September 2009 the Minister of Communications and Information Technology, Hon Steven Joyce, released updated details on the Government's \$1.5 billion Ultra-fast Broadband ("**UFB**") Initiative. The UFB Initiative is one of the National Party's most prominent election promises, with an objective to:

Accelerate the roll-out of ultra-fast broadband to 75 percent of New Zealanders over ten years, concentrating in the first six years on priority broadband users such as businesses, schools and health services, plus greenfield developments and certain tranches of residential areas.

To implement the initiative, on 29 October 2009 the Government announced the formation of Crown Fibre Holdings Limited ("**CFHL**"). CFHL is tasked with operating the

contestable selection process for private sector partners as well as managing the Government's investment in fibre networks. Briefly, the Government's plan for implementation is as follows:

- » Partners for the UFB initiative will be selected through the invitation to participate tender scheme ("**ITP**"). Firms' applications are limited to those who fit specified criteria laid out by the Ministry of Economic Development ("**MED**"), the most prominent of which is that applicants must not control a retail business;¹
- » The Government and selected partners then form commercial vehicles known as local fibre companies ("**LFC**")² to deploy the fibre networks and sell access to those products across thirty-three different regions varying in size from Auckland to Oamaru.

Final proposals for participation through the ITP scheme were due on 29 January 2010. CFHL announced that 33 proposals from 18 organisations have been received. Telecom announced that it has submitted alternative proposals - one fully compliant with the MED criteria, and the other option leveraging off its existing fibre to the node programme. It has also been reported that Auckland and Wellington would be covered under other submitted proposals (as expected). Despite it also being announced that two competitive national proposals were received, it remains to be seen whether the proposals will result in a successful roll out of "dark fibre" in a broad range of geographic areas. It also remains to be seen how the fibre will be "lit", and what services might be offered to end-users. The Government is very much taking a "build it and they will come" approach which is not without criticism. CFHL will shortly announce its process to assess and select private sector partners to participate in the co-investment scheme.

*Rural telecommunications strategy - Telecommunication Service Obligations ("**TSO**") reform and Rural Broadband Initiative ("**RBI**")*

On the back of the Government's focus to improve the quality and availability of telecommunications services in rural areas, in September last year the MED released a suite of proposals that would:

- » Change the methodology and determination process that is used by the Commission to calculate the level of compensation paid to Telecom by the industry. The result is that Telecom is likely to receive minimal (if any) compensation for its TSO obligations; and
- » Impose a new Telecommunications Development Levy ("**TDL**") on the industry. The TDL would be

used to fund projects for the development of backhaul infrastructure to improve the capability of fixed and mobile rural networks, and would also be used to make any TSO payments.

The Government estimates that it will cost \$300 million to improve rural broadband infrastructure such that services of a quality comparable to urban areas can be delivered. It plans to provide a direct contribution of \$48 million along with \$52 million "borrowed" from the UFB Initiative. The balance of the funding is intended to be sourced from the TDL: up to \$252 million of TDL funds will be allocated over six years on a contestable grants basis.

On 1 December 2009 Mr Joyce stated that the 23 submissions on the TSO proposal and 67 submissions on the RBI were positive and "give the Government a clear mandate to move quickly to improve the state of rural broadband". Final Government proposals are due in early 2010. The TSO discussion document suggested that if legislative amendments were made in early 2010, the new levy could take effect from as early as 1 July 2010.

Commission regulation

Mobile termination

The rates that one mobile company charges another mobile company to terminate voice traffic on the party's network (mobile termination charges) have been subject to Commission investigation for some years now. The current investigation under Schedule 3 of the Telecommunications Act 2001 (the "**Act**") commenced on 6 November 2008, when the Commission announced that it was investigating whether mobile termination access services should be regulated under the Act. The Commission's preliminary finding was that mobile termination charges are now significantly above cost, and the investigation has not been slowed by Telecom and Vodafone's arguments that the entry of 2Degrees shows that the market is competitive and that their mobile termination rates are not a barrier to new entry. The Commission's basic approach is that mobile termination rates can be set without competitive restraint, and are therefore a barrier to downstream competition.

The Commission recently invited Vodafone, 2Degrees and Telecom to negotiate a form of reciprocal arrangement on prices and other terms. No agreement was reached so the Commission asked the three companies to submit any revised undertakings by 15 December. Telecom and Vodafone did so, but 2Degrees withdrew all of its previous undertakings.

Telecommunications Commissioner, Dr Ross Paterson, has recently stated that no further comment will be made until the Commission's final report to the Minister for Communications and Information Technology, due this month. The Commission will recommend whether

mobile termination services should be regulated and, if so, whether Vodafone's and/or Telecom's undertakings should be accepted in lieu of regulation. The Minister will undertake further public consultation on the Commission's recommendations before the Government makes a final decision on whether and how to regulate.

Standard terms determinations

A significant feature of the 2006 reform was the introduction of section 30C of the Act, which provides that the Commission may, on its own initiative, initiate the standard terms determination process for any of the designated or specified services within the Act.

In 2009, the Commission made its finishing touches to deliver regulated access terms for unbundled bit stream and the unbundling of the local loop (as provided for in the Telecommunications Amendment Act 2006). It delivered a final determination on the sub-loop services of unbundled local loop, co-location and backhaul, and reviewed and clarified the unbundled bit stream and unbundled copper local loop standard terms determinations.

Operational Separation

In March 2008, Telecom's plan to separate its operations into retail, wholesale and network, each operating at arm's-length with separate financial reporting, was approved by then Minister of Communications and Information Technology, Hon David Cunliffe. Although a substantial proportion of the undertakings have been implemented, last year Telecom requested a variation to its undertakings as it became clear that it would be unable to support the level of IT system business process change, system changes solutions and integration testing required to concurrently deliver six major undertakings by the deadline of 31 December 2009. The Minister for Communications and Information Technology, Hon Steven Joyce, approved the variation, granting Telecom a further nine months to complete the separation of shared information systems containing customer confidential information, now giving Telecom until 30 September 2010 to complete that split.

However the most significant development occurred in October, when the Commission commenced consultation on its draft decision that Telecom's wholesale loyalty offers are likely to have breached the non-discrimination and/or equivalence of input provisions of the undertakings. Telecom offered discounts on wholesale services to customers who

agreed to use only Telecom Wholesale services to provide services to a certain proportion of end-users. At issue is whether this differential treatment is allowed by the Undertakings. The Commission has reviewed submissions and is currently deciding how to apply the non-discrimination provisions in the Undertakings. On 21 December 2009 it issued draft guidelines on the application of those provisions.

Comment

Last year saw further consolidation and implementation of the extensive regulation of Telecom heralded by the 2006 amendments to the Act. Significant resources have been devoted to the implementation of extensive operational separation requirements for Telecom, and its local loop has been opened to competitors.

Although the regulatory reform of the telecommunications sector is still a work in progress, it appears clear that separation of networks from wholesale and retail, and open access to those networks, will remain at the core of the regulatory framework for the foreseeable future.

However, the Government clearly believes that over the long term this will not be sufficient to achieve its ultimate goals of a more productive economy facilitated by the "information highways" of the future. To achieve a step-change in performance, investment in new networks is required. In the absence of a sound commercial business case for undertaking that investment, the Government has committed huge sums of public funds to build the infrastructure it believes will be in the national interest.

Once implemented, telecommunications markets and services could be significantly different than the existing structure. An issue that may therefore receive greater attention is whether Telecom's separation undertakings require revising in light of developments in the fibre sphere (eg its commitment to fibre to the cabinet). It may also be timely to review the Telecommunications Act against best regulatory practice, particularly in light of the new approach to constraining and directing the exercise of regulatory power by the Commission embodied in the new Part 4 of the Commerce Act 1986 (which regulates electricity, gas and airport companies). In particular, the addition of merits review of Commission decisions has been a welcome addition to the Part 4 regime, but is a notable omission from the Telecommunications Act regime.

CONTRIBUTED BY PETRA CAREY AND CRAIG SHRIVE.

1. The full criteria are set out at the MED website under the Telecommunications headings/ITP.
2. LFCs can alternatively be based on existing business entities where those entities have the characteristics of an LFC, such as being open access fibre businesses.

REGULATORY CONTACTS:

Andrew Peterson

Partner, Auckland
andrew.peterson@russellmcveagh.com
DDI: + 64 9 367 8315
Mobile: +64 (0) 27 560 5021

Sarah Keene

Partner, Auckland
sarah.keene@russellmcveagh.com
DDI: + 64 9 367 8133
Mobile: +64 (0) 27 535 5034

Craig Shrive

Associate, Auckland
craig.shrive@russellmcveagh.com
DDI: + 64 9 367 8855
Mobile: +64 (0) 27 599 6609

Pat Bowler

Partner, Wellington
pat.bowler@russellmcveagh.com
DDI: + 64 4 819 7500
Mobile: +64 (0) 27 442 8040

James Every-Palmer

Partner, Wellington
james.everypalmer@russellmcveagh.com
DDI: + 64 4 819 7370
Mobile: +64 (0) 27 580 1616

Tim Clarke

Partner, Wellington
tim.clarke@russellmcveagh.com
DDI: + 64 4 819 7532
Mobile: +64 (0) 27 224 5843

Catherine Marks

Consultant, Wellington
catherine.marks@russellmcveagh.com
DDI: + 64 4 819 7845
Mobile: +64 (0) 27 246 2609