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Certain sections have been withheld from this document which are Telecom confidential information, or which are legally privileged.

REGULATORY IMPACT STATEMENT

REGULATORY ISSUES RESULTING IF TELECOM BECOMES A PARTNER IN THE ULTRA-FAST BROADBAND INITIATIVE

AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement (**RIS**) has been prepared by the Ministry of Economic Development (**MED**).

It provides an analysis of options that relate to the scenario whereby Telecom Corporation of New Zealand Ltd (Telecom) partners with the Government in the ultra-fast broadband (**UFB**) initiative. To meet the conditions of the UFB, Telecom has offered to structurally separate, by way of a de-merger of its current business units. The proposals in this paper will not be relevant in the event that the Government does not partner with Telecom.

Problem definition and core objectives

A structural separation of Telecom, as the incumbent telecommunications company with significant market share, constitutes a major shift in market structure. As a consequence, the regulatory regime needs to change accordingly. The purpose statement of the Telecommunications Act 2001 (the **Act**) is to ensure the promotion of competition in telecommunications markets for the long term benefit of end-users. The core objective of the proposals in the accompanying Cabinet paper is to ensure any of the consequential changes to reflect structural separation still preserve the core competition and efficiency goals of the Act.

The actual process of separation requiring a change in corporate form from one company to two (for the purposes of this analysis known as **Chorus2** and **ServiceTel**) will also, absent any mitigating measures, prove to be prohibitively costly to Telecom and could disadvantage the two new companies. In these instances relating to Telecom, the objective is to ensure that structural separation neither advantages nor disadvantages Telecom, that no substantial diminishment of other peoples' rights occurs through the process, and that the costs of structural separation are not prohibitive.

Background

The policy process for the implementation of the Government's UFB Initiative sets a challenging timetable, which has impacted on the time available to prepare this RIS. It does however cover the key options and effects of the proposal contained in this Cabinet paper. It can in some respects be seen as several Regulatory Impact Statements incorporated into one paper, given the number of consequential changes that would result from structural separation.

This RIS covers the impact of structural separation on:

- the copper based regulatory regime, including associated transitional arrangements;
- the Telecommunications Service Obligations;
- existing Operational Separation provisions;
- line of business restrictions;
- issues under the Commerce Act 1986; and
- Telecom's position after de-merger, and any consequential changes required.

Key assumptions, constraints, trade-offs, and risks

The assessment involves a number of **assumptions**. It assumes Telecom is a preferred partner in the UFB Initiative, and also that structural separation is Telecom's response in order to meet the Government conditions to participate in the UFB. It is further assumed that the analysis is based on the structural separation model proposed by Telecom, and that Government is not willing to consider imposing an alternative form on a public company.

The changes in this paper are also conditional upon Telecom shareholders voting to proceed with a de-merger (in June 2011), and approval for the scheme being granted by the High Court.

Timing constraints have been imposed by the policy process. The analysis into the structural separation of Telecom and the proposed regulatory changes has largely been qualitative, rather than quantitative in nature. The Government has made it clear to MED that further investment above that indicated for the UFB and Rural Broadband Initiative (**RBI**) is not under consideration, and so options that require additional government funding as a potential solution have not been given full consideration.

A further constraint is that, at the point of proposing regulatory changes, the exact split of assets, and precise governance arrangements, between the de-merged Telecom entities is not known. This exposes the process to some risk, including the prospect that final proposals from Telecom include elements that could be considered anti-competitive in nature. A process for approval to ensure that the asset split does not raise any issues is proposed. Proposals aimed at monitoring the sharing of any assets, systems and services between Chorus2 and ServiceTel during a transitional phase are also contained in the Cabinet paper to address any risks.

A full analysis has not been undertaken for the purpose of this RIS of the economic benefits of moving to fibre based networks from the current fixed line infrastructure, as such decisions have already been made previously by Cabinet in the formation of the UFB policy. Similarly, a full competition analysis of the interdependencies of regulatory decisions relating to the copper and fibre networks has not been undertaken.

In recognition that the UFB and Rural Broadband Initiatives will have a significant impact on telecommunications markets in New Zealand, and that the forbearance period for fibre will finish in 2019, we are proposing:

- a review of the Telecommunications Service Obligations (TSO) with recommendations being made in December 2013; and
- a review of the overall framework for regulating telecommunications services in New Zealand no later than 1 January 2018. The details of this review are included in the Cabinet paper – “*Government Broadband Policies: Implementation Matters*”.

The measures recommended in the accompanying Cabinet paper and as a result of decisions already made by the Government to stimulate investment in a fibre network, involve some **trade-offs**. Changes in pricing methodologies proposed are likely to make the business case for further unbundling of the copper local loop less attractive. This could in turn impact on consumers of broadband as there is a risk of higher retail broadband prices. MED believes this effect is mitigated to some extent by other broadband wholesale products (known as “bitstream” services) moving to cost-based pricing. Nevertheless, the implications of some of the regulatory changes involve some explicit trade-offs between copper and fibre based services, with some of the measures favouring a shift to services delivered over a fibre access network.

Consultation has been carried out on the regulatory implications of structural separation through a discussion document in September 2010, and the views of submitters have been considered in determining final policy proposals. However, it should be noted that some details have arisen as a result of developing final proposals – for example, with regard to transitional arrangements to mitigate the impact of changes to pricing regulated copper access products. It is intended that the public’s views on such matters be sought at the Select Committee stage.

A number of issues arising through discussions with Telecom regarding the detail of separation, (for example, tax issues) have not been subject to public consultation. This is due to the fact that these issues involved commercially confidential information pertaining to Telecom, and do not impact on the rest of industry.

Effects that would require a strong case before regulation is considered

The proposals have been intended, where possible, to translate current regulatory settings to a post-separation scenario. Some of the proposals may impact on market competition over the copper network, as noted in relation to the trade-offs above.

Where additional costs may result for businesses and/or impact on incentives to invest, as in the case of those companies that have investments in copper local loop unbundling, measures have been proposed to mitigate the impact, such as transitional arrangements.

Some of the proposed changes that result from a change in Telecom’s corporate form can have consequential impacts on private property rights. Where this is the

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case, MED believes these issues have been managed in such a way that peoples' rights are not in substance worse than the currently situation.

In summary, MED believes the balance struck as part of these proposals is appropriate.

Bruce Parkes
Deputy Secretary
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STATUS QUO AND PROBLEM DEFINITION

Key features of current telecommunications policy, regulation and the market

- 1 This paper is provided in the context of a set of policy drivers to accelerate the uptake of faster broadband, a regulatory framework predicated on Telecom as a vertically integrated company subject to specific regulations relating to the operational separation of three business units, and a market where competition over copper access networks is maturing, but the market for fibre local access networks is in its infancy.
- 2 The key relevant *policy* features are that:
 - a the Government has established the Ultra-fast Broadband (**UFB**) Initiative, as it sees faster broadband delivered over a fibre-optic network (rather than a copper based access network) covering 75% of the population as enabling economic growth opportunities;
 - b to achieve long term competitive outcomes from the UFB Initiative, the Government has stipulated that it will only invest in Local Fibre Companies (**LFCs**) that are not controlled by shareholders who also operate retail telecommunications businesses. Telecom Corporation of New Zealand Ltd (**Telecom**) is the only company affected by this requirement; and
 - c to meet the condition, Telecom has offered to structurally separate, by way of a de-merger. Under their proposal, the network and wholesale arms of Telecom would become **Chorus2**, who would partner with the Government in the UFB initiative, and there would be a separate retail company, **ServiceTel**.
- 3 In regulatory terms, the current regulatory regime is predicated on Telecom as a vertically integrated company. A change from a vertically integrated incumbent with a high degree of market power to two structurally separate companies requires a re-assessment of whether settings appropriately reflect industry structure. The current regime has certain in-built assumptions and has been built around the current industry structure and a set of binding Undertakings that enforce operational separation of Telecom's separate business units – the network access unit (Chorus), wholesale, and the retail unit.
- 4 Other relevant features of the current situation are that:
 - a the 2006 amendment to the Telecommunications Act 2001 (the **Act**) introduced local loop unbundling, and an amendment to existing

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bitstream services. Competition over the copper network is increasing and the market is maturing¹;

- b but fibre access networks are still considered in their infancy. There is some commercial activity but still very limited development of fibre being installed to the home. Further, some of the current regulatory settings may be impeding fibre roll-out, such as the local service TSO that requires a certain standard of voice service to be delivered over copper, and not fibre;
- c key decisions on the regulatory framework relating to the UFB Initiative relating to fibre networks were agreed by Government in July. The Government's preferred approach is to set the pricing and terms for fibre products through a competitive process with bidders to the UFB process, and setting those terms by contract through a process undertaken on behalf of the government by Crown Fibre Holdings (CFH). The key features of the regime already agreed include:
 - i Local Fibre Companies (**LFCs**) must not provide retail services and must provide specified layer 1 and layer 2 access services;
 - ii pricing agreed through the regime is regulated by way of contract for a 10 year forbearance period. The LFCs will be prohibited from raising prices unilaterally;
 - iii LFCs will be subject to binding Deeds of Undertaking setting out open access rules, applying for the entire forbearance period;
 - iv these Deeds have legislative backing and will be monitored and enforced by the Commerce Commission;
 - v the Commission will have significant information gathering powers over LFCs to enable it to monitor compliance;
 - vi LFC reference offers and all variations on the reference offers will be made public on the LFCs' website, providing transparency.
- d Telecom is the provider of the Local Service Telecommunications Service Obligations (TSO) Deed, a service agreement between the Crown and Telecom to undertake such commitments as maintaining a free local-calling option for all residential customers, meet specified service quality standards, and charge customers in rural areas no more than the standard residential rental.

¹ The uptake of unbundled copper loop connections has risen to approximately 68,000 lines (approx. 3.6% of lines) in June 2010. This growth in New Zealand appears to be higher than the uptake in other countries at a similar stage of unbundling. Source – Commerce Commission. The competitor share of growth (i.e. companies other than Telecom) in retail broadband (DSL) connections has grown since 2006, and is now approximately 70% of growth.

Cost/benefit of the status quo and core problem definition

- 5 Taking the status quo to mean the current regulatory settings, and judged against the purpose of Telecommunications Act to promote competition for the long term benefit of end-users, there has been an increase in competition over fixed line networks in the period since the 2006 reforms. The market can be said to be functioning in the short term. In the absence of any further government action, the expected outcome is that competition in the telecommunications and broadband market over the copper access network would continue to increase, with likely consequent benefits in terms of price and choice for consumers.
- 6 While this meets Government's short term objectives in relation to competition and incentivising investment, it does not meet the medium to longer term objective of the UFB Initiative of transitioning to a fibre access network with consequent higher speed and capabilities.
- 7 To the extent that trade-offs are required, parts of the proposed package are likely to reduce incentives to invest in unbundling of the legacy copper network, but will improve incentives to invest in the fibre network.
- 8 As outlined above, assuming Telecom's participation assists in meeting the long terms objectives of the UFB Initiative, this necessitates a set of regulatory changes. The key problem that the proposals in the accompanying paper seek to address is that the current regulatory structure is not designed to, and would not effectively support, a structurally separate incumbent operator. However, some competition and regulatory challenges would remain and regulation is likely to be necessary to avoid monopoly pricing, unless competition from alternative networks emerges.

OBJECTIVES

- 9 In the Discussion Document on *The Regulatory Implications of Structural Separation* released in September 2010², MED stated a set of objectives that are relevant in guiding this assessment, including the main purpose of the Act "to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand."
- 10 The Government's ultra-fast broadband (UFB) Initiative objective is as follows:

"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 users" such as businesses, schools and health services, plus greenfield developments and certain tranches of residential areas."
- 11 In summary, the common objectives for the options in this assessment are to:

² Discussion Document on the Regulatory Impact of Structural Separation - http://www.med.govt.nz/templates/MultipageDocumentTOC_44742.aspx

- a provide long term benefits to telecommunications end-users in New Zealand in terms of price and quality;
- b efficiently achieve the goal of making the UFB available to 75% of the population;
- c achieve the outcomes sought under the TSO Deed; and
- d through the corporate transition process from one to two entities, Telecom is neither advantaged nor disadvantaged, and there is no substantial diminishment of other peoples' rights.

REGULATORY IMPACT ASSESSMENT: KEY ELEMENTS OF THE PACKAGE

- 12 The regulatory changes proposed are set out and analysed in the following sections, representing the key elements of the package should structural separation proceed:
- a the copper based regulatory regime and transitional arrangements;
 - b TSO;
 - c operational separation;
 - d line of business restrictions;
 - e authorisation under the Commerce Act 1986; and
 - f consequential changes required to preserve Telecom's position after de-merger.

The structural separation model proposed by Telecom

- 13 The following proposed split of assets, based on information provided by Telecom, is used as the basis for the following analysis. As part of structural separation, Telecom's current wholesale unit's functions will be absorbed within two structurally separate companies, known for the purpose of this analysis as Chorus2 (the network business) and ServiceTel. MED's current understanding is that the split will be as follows:
- a Chorus2 assets will consist of:
 - i the access network (i.e. the local copper network including poles, ducts and cabinets);
 - ii most exchanges and regional backhaul links;
 - iii current and future fibre assets (including assets to be rolled out pursuant to UFB, should Telecom be a successful tenderer);
 - iv active electronics; and

- b ServiceTel's key assets would likely be PSTN capability (e.g. PSTN switches – to provide telephony services), the mobile network and national backhaul links (also known as the core network).

SECTION ONE: COPPER BASED REGULATORY REGIME – IMPACT OF STRUCTURAL SEPARATION

OVERARCHING PROBLEM DEFINITION AND ISSUES

- 14 Structural separation will have an impact on the provision of copper based access services. The access regime for copper products was based on the operationally separate network, wholesale and retail businesses of Telecom. Structural separation changes the divisions and the key implications for the access regime are as follows:
 - a unbundled bitstream service (**UBA**) pricing is calculated using a retail-minus pricing methodology, referencing prices from Telecom Retail. Under structural separation, it will not be appropriate for Chorus2's regulated services to be priced by directly referencing the retail prices of one of its customers (ServiceTel), so a different pricing methodology is required;
 - b the split has implications for the provision of wholesale access services. Some service combinations, for example clothed UBA, consist of an analogue telephone service using PSTN assets that will now be operated by ServiceTel, in combination with broadband equipment operated by Chorus2. Structural separation accentuates the impacts of current pricing methodologies for broadband and voice services, as discussed below under "Averaging of UCLL"; and
 - c the need to consider transitional measures to protect: access seekers; the demerged Telecom entities, and end-users, during a period of substantial structural change for the industry.
- 15 The regulated access regime for copper-based fixed access network services was reformed in 2006 to introduce a series of new regulated services designed on the basis of the "ladder of investment" LOI regulatory framework. An LOI framework takes the form of tiers of regulation that allow access seekers to climb the value chain by initially purchasing lower-value-add regulated wholesale services (such as resale and bitstream services) and then transitioning to higher-value-add regulated wholesale services that require them to invest more themselves in more replicable network elements – such as installing their own equipment in Telecom exchanges to deliver unbundled local loop services (**UCLL**).
- 16 The objective of this approach is to drive competition deeper into the market and create greater opportunities for differentiation by competitors and higher levels of innovation. MED considers the LOI access regime has been successful in promoting competition, resulting in significant end-user gains from price decreases and a greater choice of services.

- 17 To incentivise movement up the LOI, the Commission is required to consider the relative prices between the two key services, UCLL and UBA, to place relative incentives on access seekers to move from UBA to UCLL.

Regulated service family	Example of regulated service	Method of regulated pricing	Additional value added by access seekers
UCLL	UCLL	Forward Looking Cost-based (TSLRIC)	DSLAMs, backhaul links, PSTN emulation
Bitstream/UBA	EUBA + POTS	Retail minus imputed costs	National and International connectivity, Layer 3+
Resale	Resold broadband	Retail – x%	Retailing

Table 1: Current wholesale fixed access services provided by Telecom

- 18 There are some inherent trade-offs between the current regulatory regime for copper designed to drive competition deeper into the market and investment in further copper-based infrastructure, with incentives to invest in products and services that will be available over the UFB fibre networks. These trade-offs are discussed in the section below on averaging of UCLL.
- 19 Submitters on MED’s Discussion Document “Regulatory Implications of Structural Separation” made the following key points:
- a amendments to the access regime necessitated by structural separation should be made by either:
 - i the Commerce Commission using its powers under Schedule 3 of the Act to alter the regulated services in Schedule 1; or
 - ii the Government following a more careful study of the issues including quantitative analysis.
 - b any such amendments should be considered in a broader context following the publication of the prices and other terms negotiated by CFH for fibre-to-the premises access services.
- 20 The option of making these changes through a Commission Schedule 3 process was considered as part of the process, but not pursued on the basis that the timeframe for a Schedule 3 process would extend beyond separation day. Telecom requires a degree of certainty to proceed with the separation process as to how the regulatory access regime will apply to the separated companies.

- 21 The main risk of taking this approach is that it could be expected to undermine the integrity of existing regulatory institutions. The processes for determining prices are clearly set out in the Telecommunications Act, and allow for proper consultation before a final decision is made. To bypass this process will incur a cost both in terms of regulatory certainty, and possibility in terms of a sub-optimal decision on pricing to the extent that the proposed processes are less robust.
- 22 A constraint on this exercise is that, in order to meet the timeframes specified by the UFB policy to expedite the roll-out of broadband, it has not been possible in the timeframes and with the resources available, to undertake a quantitative analysis. While MED considers that the addition of quantitative analysis is preferable, the qualitative analysis provides a basis to inform the recommendations.

OBJECTIVES

- 23 The objective of amending the access regime is to translate, as closely as possible, the status quo into the new structurally separated environment. In doing so, the focus has been primarily on maintaining the ability of access seekers to provide the same retail services to end-users.

Pricing methodologies

Analysis of options

- 24 As indicated above, current bitstream service (UBA) pricing is calculated using a retail-minus pricing methodology, referencing prices from Telecom Retail. Under structural separation, it will not be appropriate for Chorus2's regulated services to be priced by directly referencing the retail prices of one of its customers (ServiceTel), so a different pricing methodology is required.
- 25 Key options considered for the *process* to amend the pricing methodologies for Unbundled Bitstream Access (UBA) were as follows:
- a to set an initial pricing principle as the cost of the copper local loop network plus benchmarking additional costs against prices in comparable countries, with a final pricing principle as the cost of the copper local loop network plus Total Service Long-Run Incremental Cost (TSLRIC) of additional costs. In this option, the Act would be amended to allow for application of the final pricing principle upon application by either an access provider or an access seeker following the Commission's implementation of the initial pricing principle; or
 - b an alternative option is to follow the Commission's established processes under the Telecommunications Act, with the Commission using its powers under Schedule 3.
- 26 In terms of *pricing methodologies*, the two internationally accepted methodologies for bitstream services are retail-minus and cost-based pricing,

but as the former is no longer appropriate, MED consulted on the following cost-based pricing options:

- a benchmarking cost-based prices and/or cost estimates;
- b a cost-building block methodology building on the existing cost-based UCLL prices; and
- c cost-modelled prices.

Preferred options, effects and regulatory impact

- 27 The preferred process option for UBA pricing is option (i) above. MED believes the need for certainty about how the access regime will operate, and for Telecom and the industry to be aware of the costing principles that will apply to the separated companies before separation day, outweighs the benefits of application of the standard Schedule 3 process in this instance.
- 28 Submissions did not provide detailed views on the exact form of the pricing principles. Most commenting submitters noted that it was difficult to comment on the specific pricing principles without understanding the likely resultant pricing.
- 29 MED considers that the best alternative is to adopt a cost-building block methodology building on the existing cost-based UCLL prices. The additional cost-blocks will be, in the initial pricing principle, forward-looking cost-based prices benchmarked against prices in comparable countries and, in the final pricing principle, TSLRIC building blocks. This provides the most certainty for the industry because it uses:
- a UCLL prices, which are prices that are both benchmarked against forward-looking cost-based priced and actually applying in the market; and
 - b TSLRIC, which is a widely applied and understood regulatory methodology used to price other cost-based services in the Act.

Consequential changes to other regulated services

- 30 Changes to cost based pricing and determining that the UBA service is the service that recovers the costs of the copper local loop has consequences for other services. Mechanical changes are required to local access and calling regulated services so these services can be provided in a structurally separated environment, and a new service for "Low Frequency Voice Input" needs to be created so that the current regulatory options remain available to access seekers. These consequential changes have not proved contentious with Telecom or access seekers, however the Commission considered that the amendments to the local access and calling service were unnecessary, and that there was no need to regulate the low frequency voice input service.

Averaging of UCLL

Options analysis

- 31 Structural separation causes a pricing conundrum relating to voice and broadband services. One of the core policy principles of this government and previous governments has been that, although the cost of serving urban and rural customers for a basic telephone service may differ, the price charged to consumers should be averaged across the country, as a voice service is considered an essential service. There is therefore a regulated retail voice service, through the Telecommunications Service Obligation (TSO).
- 32 However, for UCLL services which provide both a voice and broadband service to the consumer, the Commission determined in 2007 that UCLL should be de-averaged into “urban” and “non-urban” prices, leading to a current urban wholesale price of \$19.84 and a non-urban price of \$36.63. The Commission’s reasoning was that where costs vary significantly from one region to another, de-averaged prices will better reflect the underlying cost of the service, resulting in more efficient outcomes. Therefore, cost-based de-averaged prices would ensure that the appropriate signals are provided for use of the UCLL service and investment in associated infrastructure such as equipment in the exchanges, compared to an averaged price. Since introduction of the services, access seekers have only taken up the UCLL product in urban exchanges.
- 33 As one company incorporating network, wholesale and retail elements, Telecom has had some ability to cross-subsidise internally between non-urban services and urban revenue in the case of voice services that have been “averaged”. However, with structural separation, the ability for Telecom to cross-subsidise is more challenging. Also, TSO requirements oblige Telecom (and in future ServiceTel) to meet the cost of serving commercially non-viable customers, yet over time their ability to offset this loss will be eroded as competitors reduce ServiceTel’s share of commercially viable customers.
- 34 The objective of MED when considering options is to seek, where possible, consistency throughout the value chain in terms of an approach to averaging or non-averaging prices so as to avoid unnecessary market distortions.
- 35 Three broad options were considered by MED:
- a maintain the status quo of de-averaged UCLL and averaged prices for voice. This was discounted as it is not consistent with the desired objective of moving to a consistent approach across the value chain. It also unduly disadvantages ServiceTel who would be required to service commercially non-viable customers under the TSO with a diminishing ability to cross-subsidise this loss-making requirement;
 - b de-average prices for both UCLL and voice services. MED considers this approach most accurately reflects costs, and in the Commission’s view is the best outcome for competition and consumers;

- i this option was not pursued on the basis of government policy already announced in March 2010 to retain the core elements of the TSO. This option would almost certainly lead to material price increases for customers in non-urban areas. This runs contrary to the policy of this and previous Governments in terms of pricing telephony services on an averaged basis across urban and rural areas; and
 - ii options such as meeting these wider objectives other than through a cross-subsidisation from urban to rural customers by general taxation or other means were not pursued, on the basis that it is considered more appropriate for users of Telecom's services, rather than taxpayers overall, to fund the Local Service TSO obligations; and
- c average prices for both UCLL and voice services. This option will decrease the price of UCLL in non-urban centres, but will increase the price in urban areas, which is where access seekers have invested their own equipment.

Preferred option, effects and regulatory impact

- 36 Given the Government's policy noted above, the preferred approach is option (c) above to average prices for both UCLL (a change from the status quo) and voice (no change). The proposal is that Schedule 1 be amended to require the Commission to geographically average the UCLL regulated service, effective from 3 years after separation day.
- 37 This is the preferred option as it meets the objective of consistency through the value chain, and was considered to have fewer implementation difficulties than the other options considered. However, the increase in price for wholesale UCLL services for access seekers can be expected to have some detrimental impacts, and an approach to mitigate these has been established through transitional arrangements as discussed below.
- 38 The scenario of a structural separation provides a different set of circumstances from when the Commission made its decision. Under structural separation, without averaging UCLL, ServiceTel would be left with an obligation to sell a retail residential telephone price at an averaged price across New Zealand, but purchase its main input cost from Chorus2 at a de-averaged price, i.e. structural separation reduce the ability Telecom currently has to cross-subsidise internally non-urban services from urban revenue. This will risk making the TSO unsustainable.
- 39 In terms of international practice, this reflects both approaches. Averaging of UCLL is the practice in a number of comparable countries in the European Union, whereas in Australia and the US, de-averaged pricing has been pursued.

- 40 This issue is likely to be the most controversial because it will lead to increases in the price of the UCLL wholesale service in urban areas. Increases in these wholesale prices may also flow into higher retail prices for broadband consumers. However, we expect that the impact on end-users of increases in UCLL prices will be offset to a significant degree by cost-based UBA prices, and so it is not certain that retail prices will rise as a result. The proposal to “average” the regulated price is estimated by the Commerce Commission to increase the wholesale price of the urban “UCLL” product by over 20% flowing through to increased broadband prices for more than 70% of consumers. MED does not agree with this assessment.
- 41 Higher retail prices in urban areas for some services would be likely to have flow-on effects in terms of higher prices increasing the cost of telecommunications services to both residential and business. Higher pricing would result in a transfer of expenditure from other areas to telecommunications services, and/or a reduction in use of telecommunications services. Such impacts are, however, difficult to estimate. The opposite impacts would be expected in regional areas, as their prices would decrease.
- 42 UCLL averaging will also create disincentives to carrying out further unbundling of the copper local loop in urban areas. This is mitigated in some instances in that cost-based UBA will provide access seekers with an economically viable alternative to UCLL for providing retail broadband services, and access seekers must in any case combine exchange based UCLL with cabinet based UBA in all areas where unbundling has occurred, and so will benefit from changes in UBA pricing.
- 43 Further, the proposals seek to limit the impact on investors in UCLL services by providing for a 3 year transition period discussed below to enable parties to recover sunk costs in current unbundling. The decision also involves some explicit trade-offs between copper and fibre based services, and whether the long-term benefit of end-users is best realised by investment in retail services provided over the UFB networks, or further investment deeper into the value chain of the copper network through copper loop unbundling and installing equipment in copper exchanges.

Other consequent amendments

- 44 A number of consequent amendments are also proposed to address issues with structural separation. These primarily relate to services where structural separation leads to certain components of a service being in the domain of Chorus2, and other elements (e.g. POTS voice services) belonging to ServiceTel. The main objective is to re-create the services that were available before separation. Given the only viable option was to recreate such services, and the measures proposed address this intention, a fuller analysis is not included in this assessment.

Transitional measures

- 45 These transitional arrangements involve some trade-offs between access seekers, Telecom (impacts on Chorus2 and ServiceTel) and end-users.
- 46 A number of access seekers have sunk investment in UCLL (deploying their own equipment in telecom exchanges). With the pricing changes to UCLL averaging proposed above, those that have invested in urban exchanges will face increased wholesale costs for UCLL. MED considers that pricing changes to UCLL should occur 3 years after separation day, to ensure UCLL access seekers have an opportunity to recover their sunk investments.
- 47 Likewise, MED considers that the transition to cost-based UBA prices should be implemented over time, in order for access seekers and Chorus to adapt their business models to the new pricing construct and recover their sunk investments.
- 48 The following set of criteria was applied to determine which areas require specific transitional measures, or can be implemented immediately on separation day:
- a allowing access seekers to recover sunk investments in UCLL;
 - b ensuring ServiceTel is economically viable and competitive during the transitional period;
 - c ensuring that Chorus is economically viable during the transitional period and has time to adjust to cost-based UBA;
 - d giving the Commission time to implement the cost-based UBA pricing principles; and
 - e providing the industry with stability during a time of considerable structural change.
- 49 A constraint in terms of analysis is that the industry has not yet been consulted on some of the detail of the proposed transitional measures. MED seeks views on this matter at the Select Committee stage.
- 50 The three key aspects of the transitional measures are:
- a the currently determined price and non-price terms for the UBA service will be frozen, and the UBA competition test put into abeyance, for 3 years from separation day (although the Commission will be able to conduct clarifications under section 58 of the Act);
 - b ServiceTel will be restricted from purchasing Chorus's unbundled copper local loop network service until three years from separation day, and the requirement to average the UCLL service geographically will not take effect until 3 years from separation day; and

- c the determined price for naked UBA will be averaged on separation day.

Freezing UBA terms

- 51 The key transitional provision proposal is to freeze the UBA regulated service for a period of 3 years from separation day, with the intention of allowing a transition to cost-based UBA retail services where they are more economically viable. A 3 year period for the transitional provisions was chosen on a qualitative basis based on the estimated replacement period for exchange equipment (DSLAMs) deployed by access seekers. A more detailed analysis of likely depreciation values was not carried out.
- 52 Consultation noted that “freezing UBA prices for an interim period” could be included as a transitional measure, but the length of time of the price freeze was not the subject of consultation. A period of frozen UBA prices, given the trend has been for UBA wholesale prices to fall, is likely to disadvantage access seekers who primarily resell UBA, and who have not invested in UCLL equipment. A price freeze may also disadvantage consumers who may be denied lower retail prices for UBA based services during the freeze period.

Delay in averaging UCLL price

- 53 The delay in averaging UCLL will disadvantage ServiceTel which, for the period of 3 years, will be required to buy a stand-alone voice input service priced at the UCLL price, including the higher price in rural areas. However, MED considers that this delay is essential to protect access seekers who have invested in UCLL and their customers during the transitional period. ServiceTel will be protected itself by the averaging of naked UBA on separation day.

Averaging naked UBA on separation day

- 54 The price for naked UBA, which is currently de-averaged, will be averaged on separation day. As noted above, the policy decision is to average UCLL, which results in an averaging of naked UBA. UCLL will remain de-averaged during the transitional period to allow access seekers to recover investments. There is no such requirement for naked UBA. In fact, it is important to average naked UBA as it will be the input into the averaged clothed UBA service.
- 55 To protect access seeker’s and their existing customers, the de-averaged price for naked UBA will be grandfathered on separation day for existing customers. Savings provisions
- 56 Saving provisions will be required for the Standard Terms Determinations and Access Codes relating to regulated services. The Commission is currently reviewing these documents to determine what savings provisions are required.

SECTION TWO: IMPLICATIONS OF STRUCTURAL SEPARATION FOR THE TELECOMMUNICATIONS SERVICE OBLIGATIONS (TSO)

OVERARCHING PROBLEM DEFINITION AND ISSUES

- 57 The Telecommunications Service Obligations are service agreements between the Crown and a service provider for the delivery of telecommunications services which would not otherwise be delivered on a commercial basis or at an affordable price.
- 58 Telecom is the provider of the Local Service TSO Deed, which requires Telecom to undertake such commitments as maintaining a free local-calling option for all residential customers, continue a network coverage as widely as was provided at December 2001, meet specified service quality standards, and charge customers in rural areas no more than the standard residential rental.
- 59 The TSO is a “universal service” instrument that funds a set of social obligations and broader policy objectives such as ensuring parity of services for rural residents despite disproportionately higher costs incurred by operators to serve those customers. An alternative to funding these obligations through industry cross-subsidisation is to fund such obligations through general taxation. Though a number of industry consultees support such an approach, such a change would be inconsistent with the policy of this and previous Governments, and has not been included as part of this analysis.
- 60 The UFB Initiative has relevance for the Local Service TSO because the UFB networks will likely “overbuild” Telecom’s existing copper PSTN network. If Telecom is the supplier of the UFB network, it will likely seek to retire its copper network over time, necessitating changes to the Local Service TSO to provide for delivery of TSO services over FTTP access networks.
- 61 A number of policy concerns arise with respect to the Local Service TSO in the event of structural separation:
- a the Local Service TSO Deed, as currently structured, would be inoperable because delivery of the Local Service TSO Deed would require inputs from both Chorus2 (i.e. the access network) and ServiceTel (i.e. the public telephone network, or PSTN);
 - b the service requirements and quality measures in the Local Service TSO Deed can only currently be met through use of a copper PSTN network. Going forward, the Local Service TSO will need to provide for:
 - i delivery of TSO services over fibre-to-the-premise (FTTP) access networks, where these have replaced the copper access network; and
 - ii increased utilisation of alternative technologies (e.g. satellite and wireless) for providing TSO services to remote customers;

- c the funding mechanisms for the Local Service TSO may require review as investment requirements increase (e.g. when parts of the old copper network fail) and fixed-line voice revenues decline (e.g. as customers substitute fixed lines for mobile, and/or as the TSO provider loses market share to competitors).
- 62 This assessment covers options and proposals to address the implications if Telecom were to structurally separate, as this is the area directly relevant for decisions in the Cabinet paper. It does not cover recent amendments to the TSO. A review of outstanding TSO related issues is proposed in 2013 to address some of the more intractable TSO issues.
- 63 Long term issues for designated TSO providers include the increasing difficulty of meeting the cost of serving commercially non-viable customers, as opportunities to cross-subsidise any losses may become harder as competition for commercially viable customers increases. There are also key concerns as to how the Local Service TSO should be adapted over the longer term to ensure that it is sustainable and competitively neutral.
- 64 Although the suggestion of allowing telecommunications operators other than Telecom to provide the Local Service TSO was raised by a number of submitters (known as **contestability**), there remain substantial implementation issues to designing such a process to mitigate the risk of stranding customers, and technical challenges to using alternative technologies (such as satellite or fibre-based networks) to meet current service standards.
- 65 Given these challenges, the proposals in this paper do not seek fully to resolve the contestability issue, but instead the preferred option is to make amendments to the current TSO arrangements to ensure their continued operation in the event that Telecom structurally separates, and to:
- a provide a process for development of viable technology alternatives for delivery of the Local Service TSO; and
 - b require a review of the broader TSO arrangements by officials, to be completed by 20 December 2013 that will consider the potential for adopting a contestable TSO model.

SECTION TWO: OBJECTIVES

- 66 The following policy principles were applied in developing preferred policy responses to the issues identified above:
- a changes to the Local Service TSO should not harm, and preferably should improve, the outcomes experienced by end-users;
 - b subject to the first objective, the Government's TSO policy should support the most cost-efficient solutions for delivery of TSO services; and

- c TSO funding mechanisms should be sustainable and should minimise competitive distortions.
- 67 A number of key policy constraints were also taken into consideration:
- a *maintenance of key Local Service TSO features*: the Government has affirmed its commitment to the key obligations of the Local Service TSO, such as free local calling;
 - b *funding availability*: there is currently no additional Government funding specifically available for implementing new approaches to the Local Service TSO; and
 - c *timing*: it is anticipated that, if Telecom wins the UFB and structurally separates, a reformed Local Service TSO will need to be in place by separation day. The short timeframe limits the extent of reform that can be undertaken initially.

ANALYSIS OF INDIVIDUAL OPTIONS

Amending the Local Service Deed to reflect Structural Separation and a path towards Technology Neutrality

Options analysis

- 68 The Local Service TSO needs to be adapted in the event of structural separation, as it comprises both obligations to maintain a specified *network footprint* (a Chorus2 responsibility), and an obligation to supply a specified local residential telephone *service* (a ServiceTel responsibility).
- 69 MED considered options whereby the Government contract with; two parties separately; one of the parties, either ServiceTel or Chorus2, who would then sub-contract with the other party; or one conjoint contract signed by both parties. Factors taken into consideration when analysing the options were how best to ensure transparency and clarity as to which party is responsible, ease of enforceability, and how to address obligations that involve the inter-relationship between Chorus2 and ServiceTel.

Preferred option, effects and regulatory impact

- 70 The preferred approach is to create a new Local Service TSO Deed or deeds executed by, and enforceable against, two TSO providers: the Network TSO Provider (the **NTP** - Chorus2) and the Retail TSO Provider (the **RTP** – ServiceTel). This will involve a single deed or two deeds signed by both parties, the latter of the options considered above, and chosen as it should be the most transparent, easiest to enforce, and best manages inter-relationships between Chorus2 and ServiceTel.

- 71 The obligations of the deed/s would apply in respect of all *existing residential lines* (a defined term in the current deed meaning those residential access lines that were active connections as at December 2001).
- 72 The deed/s would set out technology neutral TSO outcomes that *specified TSO retail services* must deliver – these would mirror the current high-level obligations of the Local Service TSO.
- 73 The deed/s would also:
- a set out the specific obligations of both the NTP and the RTP, with appropriate and measurable performance standards; and
 - b provide for the NTP and the RTP to sub-contract to meet TSO obligations, but retaining liability. (This sub-contracting process will enable, in due course, the deployment of alternative technologies if this approach proves to be economic, and meets required service standards.)
- 74 As mentioned above, the option of moving to a contestable TSO approach (which may have included the use of alternative technologies) was considered, but not pursued at this point. However, going forward the TSO will need to cater for the delivery of TSO services over fibre access networks where these have replaced copper, and the increased use of alternative technologies (e.g. satellite and wireless) to provide TSO services to remote customers.

Emergency service calling

- 75 The current Local Service TSO Deed contains a number of requirements on Telecom in respect of **emergency service calling**:
- a the TSO service must allow an end-user to place free genuine calls to emergency services by dialling 111; and
 - b Telecom must provide emergency service calling infrastructure to manage incoming emergency service calls.
- 76 It is proposed that the first of these obligations be retained in the new Local Service TSO Deed (or deeds as the case may be). It remains important that the TSO retail service provide the functionality required to allow consumers to contact the emergency services.
- 77 However, it is proposed that the second set of requirements be redrafted as a new, separate TSO Instrument. The new Emergency Service System Deed would:
- a set out ServiceTel's obligation to provide an emergency service calling system and infrastructure;

- b provide for a specified amount of \$0 to be paid to ServiceTel, as ServiceTel does not currently receive funding for meeting those obligations; and
 - c provide for the Minister and ServiceTel to agree additional specified amounts to be paid to ServiceTel for specific emergency service calling system upgrades.
- 78 The reason for this approach is that the governance of the emergency service calling system is currently under review, and separating these obligations into a separate Deed will provide optimal transparency and flexibility in implementing the outcomes of that review.
- 79 The new Deed would also set out a process for the Minister to approve new “specified TSO retail services”. Once approved, service descriptions, technical specifications and performance measures for the service would be added to the service schedule to the Deed – hence allowing alternative technologies to be incorporated.

Summary

- 80 It is expected that the changes to the TSO Deed/s for Local Residential Telephone Service will ensure that the important consumer protections provided by the current local service TSO remain in place following a structural separation of Telecom. The changes will also provide a path toward the development of new TSO retail services that, while maintaining or improving consumer outcomes, will allow for the introduction of innovative new technologies.
- 81 To give effect to the above changes, it is proposed to amend the Telecommunications Act 2001 to provide for TSO instrument/s to have two or more TSO providers and for consequential amendments to be made to Part 3 of the Act to address how TSO-related costs, compensation, and liability for breaches should be allocated across the TSO providers in these circumstances.
- 82 The overall effect of the TSO proposals on the key parties are anticipated as follows;
- a *end-users* – assurance of TSO outcomes with clear obligations on both the Network and Retail TSO Providers to ensure consumer outcomes are not compromised;
 - b *the Network TSO Provider (Chorus2)* – increased flexibility in relation to technology choice, and options for sub-contracting network delivery in order to allow Chorus2 to optimise costs and adapt new technologies over time;
 - c *the Retail TSO Provider (ServiceTel)* - increased flexibility in relation to technology choice and sub-contracting of retail service delivery in order

to allow to ServiceTel optimise costs and adapt new technologies over time. National average input pricing ensures economic sustainability of their TSO obligations; and

- d *competing Providers* – increased options to act as sub-contractors, as Chorus2 will have incentives to sub-contract where competing providers can serve end-users more cost effectively.

83 Overall, the impact of these changes should help resolve the issues identified in the problem definition, though noting that some of the long term funding concerns relating to delivering the TSO remain unresolved. For this reason it is proposed that MED conduct a **broader review of Local Service TSO arrangements**, with the results of the review being reported back to the Minister for Communications by the end of 2013.

84 The review will investigate the statutory, contractual and funding arrangements for the TSO Deed for Local Residential Telephone Service and consider alternative arrangements (i.e. alternative technologies) and the benefits and costs of those alternatives as compared with the existing arrangements.

SECTION THREE: THE IMPACT OF STRUCTURAL SEPARATION ON EXISTING OPERATIONAL AND ACCOUNTING SEPARATION REQUIREMENTS

OVERARCHING PROBLEM DEFINITION AND ISSUES

85 Telecom is currently subject to a set of Operational Separation Undertakings, which include a set of arms length rules, such as separate management and incentive bonus arrangements to address incentives and behavioural issues. The three business units are incentivised to operate separately to meet regulatory non-discrimination requirements. The Undertakings require Telecom to supply wholesale services to customers on a non-discriminatory³ or equivalent basis⁴. The compliance costs associated with the current regime are significant.

86 Some elements of the current operational separation regime have been criticised by Telecom, and by some independent commentators, as placing excessive controls on Telecom. In the consultation carried out in September 2010, while there were mixed views about the exact number of business units following separation, there was some agreement that the current full set of operational separation requirements could be scaled back. In particular, arms length rules, and accounting separation, as covered below, require reconsideration as a result of the change from operational to structural

³ “Non-discrimination” means the service provider must offer the service to all access seekers on the same terms and conditions, except where any differences are objectively justifiable and do not harm competition

⁴ *Equivalence*” means supply of a service so that third-party access seekers are treated in the same, or an equivalent way, to the service provider’s own business operations, including in relation to pricing, procedures, operational support, supply of information, and other relevant matters.

separation. The responses to the September consultation make it clear that the industry makes very little use of the data produced by accounting separation, which brings into question the cost / benefit of maintaining such requirements on Telecom.

- 87 A move to structural separation is a significant change in market structure. It means there is no longer a fully integrated incumbent telecommunications company active in both the network and retail business, so much of the rationale for the regulations established for operational separation should be subject to review. In theory, Chorus2 would no longer have an incentive to discriminate in favour of a downstream retail arm, as it will be under a different ownership structure.

Residual incentive issues

- 88 However, a set of residual incentive problems remain as a result of the fact that the split proposed by Telecom is not an entirely clean split of functions. Chorus2 will still be supplying both passive (layer 1) and active (layer 2) products – in terms of copper products, this means they will supply both local loop (layer 1) and bitstream (layer 2) services:

- a Chorus2 will still be providing services to companies they compete with. For example, Chorus2 would be supplying Layer 1 UCLL copper services that they internally self-procure as well as supply to other retailers; and
- b ServiceTel is retaining the PSTN, which is an input services they will retail themselves, as well as an input to wholesale services that ServiceTel are expected to sell to their competitors. An example is the current resale of the product “Homeline” sold currently by Telecom Wholesale.

OBJECTIVES

- 89 The key objective of the regulatory framework, post separation, remains the promotion of competition for the long-term benefit of the end-users of telecommunications services. Other objectives are that regulation is proportionate to the problem being addressed, and that unnecessary regulation is avoided.

ANALYSIS OF INDIVIDUAL OPTIONS

Maintaining the same standard of supply

- 90 The consultation document raised the issue of whether, in a move from operational to structural separation, the standards for supply of service should be maintained or not. Currently Chorus2 has to provide UCLL and ancillary services at an “equivalence of inputs” standard, and other services (such as bitstream services) on a non-discriminatory basis.

- 91 On balance, the preferred option is to maintain some of the elements of the current operational separation regime, and include these requirements in an undertaking by Chorus2. More specifically;
- a Chorus2 should continue to provide UCLL and ancillary services at an “equivalence of inputs” standard, as this would not impose a high cost on Telecom and would be an effective means of promoting competition. Many submitters agreed that equivalence remains the appropriate principle. Telecom submitted that “Chorus2 would accept a general principle that the level of equivalence in systems and processes in Telecom today relating to UCLL would be maintained”. Telecom would not be required to make fresh investments in system development beyond those currently in place (or about to be introduced); and
 - b Consistent with submitters’ views, Chorus2 should be required to provide other services (such as bitstream services) which it supplies to access seekers, but not to itself, on a non-discriminatory basis. Although Telecom suggested that these requirements should be made “more detailed and workable”, MED supports the approach that such behaviour should be assessed on a case-by-case basis rather than being expressly permitted or prohibited. Telecom has objected to the application of a non-discrimination standard to the supply of all services by Chorus on the copper network. However, that is consistent with the requirements of the Bill in relation to fibre networks, and with Telecom’s current requirements under the Operational Separation Undertakings. It also limits the scope of Chorus2 to develop non-regulated products that can be offered on discriminatory terms.

Level of Separation and Whether Separate Business Units are required within Chorus2 and/or ServiceTel

Options Analysis

- 92 The existing Telecom Wholesale unit is likely to be divided between Chorus2 and ServiceTel as a result of structural separation. Options to consider include, in this case, whether regulatory measures are warranted to provide for separation of functions *within* the new Chorus2 and ServiceTel.
- 93 When considering the issue, MED took the following principles into account:
- a appropriate safeguards to ensure equivalence and non-discrimination within Chorus2 are required; however,
 - b any systems already built by Telecom to establish equivalence and non-discrimination and still used within Chorus should be taken into account; and
 - c no unnecessary compliance costs should be imposed on Chorus2 or ServiceTel.

- 94 MED considered whether sufficient checks on discriminatory behaviour are in place through pricing regulation of regulated products as set out in the Commission's Standard Terms Determinations (STDs), such that no additional measures would be necessary. There still remains a risk of discrimination due to misaligned incentives. Nevertheless, it was recognised that options that impose the fewest costs necessary on the new businesses should be given priority, and it was also recognised that the full set of behavioural constraints of operational separation would not need to be carried forward into the new market structure.
- 95 Consultation was carried out on the following options:
- a a "three box" model whereby Chorus2 would be required to split internally into an access network (layer 1) and a wholesale unit (layer 2) – the third "box" being the separate company ServiceTel; and
 - b a "two box" model, i.e. just Chorus2 and ServiceTel, so not requiring two separate business units within Chorus2, but still requiring Chorus2 to treat third-party access seekers in a non-discriminatory, or an equivalent way, as per the current Telecom Undertakings.
- 96 There were split views across the industry about whether a "two box model" (where Chorus2 and ServiceTel are not divided into separate business units) was acceptable after separation. There was some agreement that current requirements could be scaled back, but also some views expressed that further separation within Chorus2 and ServiceTel is warranted.

Preferred option, effects and regulatory impact

- 97 The preferred option is (b) above, i.e. not to require Chorus2 to split into separate business units for layers 1 and 2 (the "two box" model). This is the preferred option on the basis that some residual incentives to discriminate still remain, but they are not as pervasive as when all units are contained within a vertically integrated company. On balance, MED considers that internal separation is not warranted. It would not provide significant competition benefits beyond the current proposal but would create significant costs. There will also be other safeguards in place that will provide transparency about the delivery of services by Chorus.
- 98 A lower cost approach has been proposed that includes:
- a within Chorus2, equivalent systems and processes have already been built for UCLL and would be maintained for access seekers after structural separation. Most of the benefits of equivalence arise from the availability of such systems and processes;
 - b Telecom has proposed implementing a quarterly equivalence reporting regime in Chorus2 for UCLL, and quarterly customer surveys. It has also proposed service reporting to UBA customers, based on its current customer reporting. Telecom has proposed agreeing a set of

equivalence KPIs following consultation with the Commission and industry stakeholders. Telecom has also offered to enter undertakings that would require Chorus2 to internally audit key controls and processes, and to conduct quarterly reviews of compliance with the Commission. These measures should provide adequate transparency around customer treatment, and they should be built into undertakings entered into by Chorus 2;

- c there are also a number of obligations which offer protection already built into the regulated terms of supply; and
- d the Standard Terms Determinations for UCLL and UBA should be supplemented by an information disclosure policy that would implement “Chinese walls” within Chorus2. As part of the Undertakings that Chorus2 is submitting in relation to equivalence and non-discrimination, there should be provisions which would require it to implement an information controls policy in consultation with the Commission and internally audit the effectiveness of the policy every six months for the first year and annually thereafter.

99 Consultation was also carried out on whether internal separation is required within **ServiceTel**. The arguments for separation of ServiceTel turn on its continued supply of wholesale services – particularly “clothed UBA” - to access seekers who would be retail competitors to ServiceTel. To address this, MED proposes that Chorus2 be required to supply “clothed UBA”, as some submitters have suggested, if industry consultation reveals that the industry support such an initiative. This may help to deal with the perception that ServiceTel could discriminate against competitors. However, the service experience is likely to be similar for access seekers whether “clothed UBA” is supplied by Chorus2 or ServiceTel. Because the PSTN service is located within ServiceTel, it would not be possible to make Chorus2 the exclusive supplier of “clothed UBA”.

100 Ownership of the PSTN gives rise to potential conflicts over the supply of wholesale services. MED supports a low cost and effective way of dealing with the issue through requiring ServiceTel to continue to publish KPI reporting on its resale services. Other than “clothed UBA”, these are the primary wholesale services reliant on PSTN inputs. This is considered to provide sufficient transparency to support competition.

Other changes as a result of structural separation

Confidential information

Options analysis

101 The options with regard to managing confidential information include retaining the arrangements in place under operational separation; maintain some rules proportionate to the level of residual incentive issues, or removing such arrangements.

102 While MED considers that it will be unnecessary to maintain separate internal business units governed by arms length rules, it will nevertheless be important to maintain rules governing the treatment of confidential information within Chorus2.

Preferred option, effects and regulatory impact

- 103 It is proposed to deal with this through:
- a retaining safeguards that relate to the terms and conditions of core regulated products (where there is a risk of favouring their internal business over that of other companies). The Standard Terms Determinations for the regulated products – UCLL and UBA – will apply to Chorus2 and contain detailed information control obligations; and
 - b putting in place an information disclosure policy that would implement a “Chinese walls” policy within Chorus2 as set out above.

Internal governance and independent oversight

Options analysis

104 Currently there is an Independent Oversight Group (IOG) in place, a cost met by Telecom. The IOG performs a role that was considered important in the context of monitoring the behaviour of the three business units in Telecom, but under structural separation, the options of whether to retain the arrangements, or consolidate the oversight role as part of the Commission’s responsibilities need to be considered.

Preferred option, effects and regulatory impact

105 It is proposed that the IOG be disestablished. The cost is not considered to be warranted with a smaller Chorus2, and where the conflict of interest issues are less significant. Submitters were on the whole comfortable with the Commission performing the role – in fact MED considers that there are potential benefits in aligning the monitoring, enforcement and Undertakings variation functions within one organisation - the Commission.

Accounting separation

Options analysis

106 The accounting separation obligations that are currently in place only apply to Telecom, and not other telecommunications companies. The Commission requires Telecom to prepare and disclose information about the operation and behaviour of all or any of its network, wholesale, and retail business activities as if those activities were operated as independent or unrelated companies.

107 The question posed in consultation was whether the same obligations should be rolled over to apply to Chorus2 in respect of copper services. The rationale

for accounting separation was to reveal information about the operation and behaviour of Telecom's business units as if they were operating independent or unrelated companies, and it also has a broader purpose of informing and providing transparency for a wider set of stakeholders about Telecom's business activities and services.

- 108 Accounting separation is a costly remedy, and needs to have a clear rationale. The rationale is no longer clear and the dominant view of submitters was that the current accounting separation arrangements should be discontinued. There were, however exceptions to this view, with a number of proposals for less intrusive substitute regimes. Vector, InternetNZ and 2 degrees did not agree that accounting separation arrangements should be removed.
- 109 The Commission has suggested that an extensive information disclosure regime similar to that proposed for fibre networks should be applied to legacy copper services, through an amendment to the Act. The Commission notes that this would provide consistency of approach between the copper and fibre networks. The Commission has also suggested that an information disclosure regime of this kind would assist in apportioning costs accurately between fibre and copper.
- 110 While there are generally advantages to consistency of regulation between the copper and fibre platforms, in this case, the policy environment justifies a different approach in each case. In the case of UFB fibre networks, there will be a relatively light handed regulatory regime while the industry matures. The additional transparency provided through information disclosure will be an important safeguard to reveal whether fibre providers are developing market power. It will also be an opportune means of capturing accurate information about the costs of the new network, and therefore, of avoiding any regulatory arguments that might arise about the costs of assets in the future.
- 111 In the case of copper networks, the Commission has set, or will be setting, cost-based prices for the key services, which should be an adequate and more direct safeguard against market power. In these circumstances, the arguments for consistency between copper and fibre are weaker. Expanding the scope of the new information disclosure rules to include copper legacy networks will mean that the compliance costs of accounting separation will remain, even though the benefits are fewer. MED therefore proposes that the information disclosure rules in the Telecommunications (TSO, Broadband and Other Matters) Bill continue to apply to fibre only, and that the accounting separation provisions of the Act should be removed.

Preferred option, effects and regulatory impact

- 112 It is proposed that additional transparency on non-price terms can be delivered through establishing KPI reporting as part of Undertakings to be submitted by Chorus2 in relation to equivalence and non-discrimination. A single Deed will be negotiated with Chorus2 to govern all its open access obligations in relation to both the fibre and the copper businesses. The

Commission will have its standard information gathering powers to support its enforcement function in relation to this Deed.

- 113 The preferred option is to remove the requirement for accounting separation, through an amendment to Part 2B of the Telecommunications Act.

PSTN migration

- 114 The current Operational Separation Undertakings require Telecom to migrate its retail voice customers from the legacy PSTN service to an alternative IP based voice service. There are a number of interim milestones, but the Undertakings require Telecom to have migrated all Telecom customers off PSTN services by 31 December 2020. If the obligation was to be retained after structural separation, it would have to apply to ServiceTel.
- 115 The original policy rationale behind PSTN migration was to facilitate the consumption by Telecom of equivalent inputs for all key services (including voice), and to deal with the apparent threat of obsolescence of Telecom's PSTN technology. PSTN replacement seemed consistent with international trends, and with Telecom's own strategic goals.
- 116 Telecom now believes that it can continue to maintain its PSTN technology. Telecom's concerns about the costs and complexities of a transition to an IP-based voice service have also increased. Telecom is therefore proposing, in the context of structural separation, that it be relieved of the PSTN migration obligation.
- 117 MED agrees that migration to an alternative voice platform on this scale to a rigid timetable determined by Government is risky. There is a credible risk of significant customer disruption if the current obligations were to be transferred to ServiceTel following separation.
- 118 This may defer delivery of equivalence for the voice service, and may create some incentives for ServiceTel to keep customers on the copper network. However, the additional advantages for access seekers of ServiceTel using equivalent systems and processes are not substantial enough to offset the risks identified above.
- 119 The preferred option is that the current migration requirements in the Undertakings are not imposed on ServiceTel.

SECTION FOUR: LINE OF BUSINESS RESTRICTIONS

PROBLEM DEFINITION AND ISSUES

- 120 Structural separation affects the fundamental structure of the telecommunications industry. Given the significant nature of this kind of separation and the regulatory amendments required to reflect the change, it will be important to ensure that the objectives of structural separation are not unwound by future changes in industry structure. For example, future entry by

Chorus2 into retail product markets would create the same incentive problems that currently exist, which structural separation is designed to remove.

- 121 The key policy objective is to ensure that, in the event of a structural separation, the regulatory framework still meets its core purpose, and that the new industry structure is durable and stable.

OPTIONS ANALYSIS

- 122 Consultation was undertaken on whether to retain line of business restrictions on Chorus2 and ServiceTel (i.e. to prevent forms of re-integration that could give rise to undue advantage). In the Discussion Document on structural separation in September, most submitters (including Telecom) supported line of business restrictions on Chorus2.

- 123 In the Discussion Document, MED also sought feedback on whether any restrictions should apply to ServiceTel. There was very limited support for imposing such restrictions.

PREFERRED OPTION, EFFECTS AND REGULATORY IMPACT

- 124 The preferred option is to establish line of business restrictions that apply to Chorus2, but not to ServiceTel.

- 125 MED considers that line of business restrictions would be required for Chorus2 with the purpose of preventing Chorus2 from reintegrating to participate in downstream markets (i.e. retail) where it could have an undue advantage arising from its market power in upstream access network service markets.

- 126 However, in designing such restrictions, MED is mindful of the objective of ensuring Chorus2 is not unduly constrained, and would be able to innovate, and contribute fully in markets where competition concerns do not arise.

- 127 The proposal is that the Telecommunications Act should be amended to prevent Chorus2 from future participation, either directly or indirectly, in:

- a the supply of services to end users;
- b the supply of services above layer 2; and
- c backhaul services other than the regulated backhaul services currently in Schedule 1 of the Act.

- 128 Taken together, these restrictions would limit Chorus2's ability to enter lines of business that would affect its incentives to discriminate against its customers.

- 129 The legislation would provide for specific prohibitions on supply of defined services, either by defining the service, or by defining the class of customer that can be (or must not be) supplied.

- 130 Line of business restrictions are not proposed for ServiceTel. There was almost no support for imposing such restrictions by submitters. However, as part of the transitional provisions associated with moving to an averaged UCLL price, it is proposed to place a transitional prohibition on ServiceTel acquiring UCLL services so that it cannot unbundle.

SECTION FIVE: AUTHORISATION UNDER THE COMMERCE ACT 1986

PROBLEM DEFINITION AND ISSUES

- 131 In the scenario whereby the Government partners with Telecom for the UFB Initiative, the same entity (i.e. Chorus2) would own the copper and UFB fibre networks. In this case, there is an argument that there would be less competition between the copper and fibre networks than a scenario where the Government partners with companies other than Telecom.
- 132 Officials have sought legal advice

133

OPTIONS ANALYSIS

- 134 Options considered involve either taking no regulatory action; seeking an authorisation under the Commerce Act (which would involve the Commission assessing the potential transaction and providing an authorisation if appropriate); or pursuing an express authorisation through legislation.
- 135 Taking no action would lead to a situation of uncertainty around the decision regarding a potential breach of the Commerce Act, leaving the potential for litigation. This uncertainty would likely mean that a price premium would be included by Telecom in its proposal.
- 136 An authorisation could be sought under the Commerce Act with the Commission assessing the potential transaction. This process would impact on the Government's preferred timing for completing UFB arrangements. The Commission's process for considering authorisations is very thorough, involving investigation, consultation and analysis. Typically, authorisations take months to complete, even for relatively straightforward cases.
- 137 An express statutory authorisation provides for the timeliest outcome and supports meeting UFB objectives, and removes an area of regulatory

uncertainty from the process. However, this means bypassing the standard process undertaken by the Commerce Commission.

- 138 As with by-passing Schedule 3 processes, the main risk of taking this approach is that it could be expected to partly undermine the integrity of existing regulatory institutions. The processes for authorising equity and trade practice arrangements are clearly set out in the Commerce Act and in supporting guidance. They allow for proper consultation before a final decision is made. To bypass this process will incur a cost in terms of regulatory certainty. There is a risk that if the Government is seen to avoid its own rules, that may have adverse impacts on investment, and could encourage private sector lobbying for similar treatment. Relative to the Schedule 3 exception, which is industry-specific, the impact of avoiding the Commerce Act processes could be widespread.

PREFERRED OPTION, EFFECTS AND REGULATORY IMPACT

- 139 The proposed option is an express statutory authorisation on the basis of reducing uncertainty and delay to the UFB process, and the ability to manage the migration of customers from copper to fibre under a Telecom scenario. These factors are considered, on balance, to support the approach taken.
- 140 Any authorisation would be drafted narrowly to only cover the arrangement, and would be drafted in consultation with the Commerce Commission. The Dairy Industry Restructuring Act 2001 provides a precedent for an express statutory authorisation being given.

SECTION SIX: CONSEQUENTIAL AMENDMENTS REQUIRED TO PRESERVE TELECOM'S POSITION AFTER DE-MERGER

OVERARCHING PROBLEM DEFINITION AND ISSUES

- 141 If Telecom proceeds with structural separation, the arrangements will be of considerable cost to Telecom, and will likely result in ongoing compliance costs to meet regulatory requirements. The scope and scale of structural separation extends to tax implications, and ownership of, and access to, assets and land whereby the creation of two separate corporate entities creates a number of complications. Although many of these issues are appropriately the domain of Telecom to resolve contractually, without some legislative amendment, structural separation will be prohibitively expensive, and would be unlikely therefore to proceed.
- 142 The key areas covered in this section relate to:
- a tax;
 - b transfer of ownership of land to Chorus2 (and implications for the Public Works Act 1981) and the impact of restrictive covenants, both of which have some implications for private landowners;

- c Chorus2's ownership of parts of the network, and implications for "network operator status" under the Telecommunications Act, and "requiring authority status" under the Resource Management Act, along with the benefit of relevant designations;
 - d Chorus2's ability to access lead ins (cables into a customers' premises); and
 - e the transfer of land access arrangements (licences and other access agreements), and the potential for contract counter-parties to use this situation as an opportunity to generate windfall gains.
- 143 Some of the proposals below have an impact on landowners. However, in the scenarios and options discussed below, the issue of the rights and impact on counter-parties such as landowners, arise not as a result of a material change, but as the result of matters consequent to a change in corporate form – from one entity Telecom, to two separate entities Chorus2 and ServiceTel. In most cases, for example, the material effect of the proposed legislative changes is to confer a status on, or to provide equivalent protections to, Chorus2 and/or ServiceTel that Chorus/Telecom exercise now.
- 144 A number of the matters that arise, consequent to the corporate change lead to a set of delays, process, and cost that in some cases are considered by Telecom to be at a prohibitive level. MED has not undertaken an independent assessment of whether all the costs cited by Telecom are reasonable estimates. However, MED's qualitative assessment is that the costs are material enough in a number of instances to impact on the decision as to whether structural separation is a viable proposition. Each point where there is an impact on counter-parties is set out below for individual assessment, noting that consultation has not been carried out on these issues.

OBJECTIVES

- 145 The intention of the proposed changes are to neither advantage nor disadvantage Telecom through the process, and ensure no substantial diminishment of other peoples' rights through the process. The following objectives have been established in the process of considering any legislative change:
- a to ensure that the structurally separated companies are not penalised for separation by, where possible (and relevant), providing:
 - i Chorus2 and ServiceTel with equivalent (but no greater or lesser) rights to those that Telecom currently has;
 - ii while also ensuring that other peoples' rights are not, in substance, worse than they currently are; and
 - b to ensure that the costs of structural separation are not prohibitive.

ANALYSIS OF INDIVIDUAL OPTIONS

Tax

Options analysis and preferred option

- 146 The taxation objective of any de-merger is to ensure that the de-merger does not itself trigger taxation consequences that advantage or disadvantage the entities involved, in this case Telecom, ServiceTel, Chorus2 or the shareholders. The term "tax neutral" is used to describe this. At the time of the de-merger the same shareholders will hold the same interests in assets and businesses, via shares in two companies (ServiceTel and Chorus2) rather than one (Telecom).
- 147 Many of the proposed tax neutral measures are based on precedents over the past 20 years for corporate restructures, however, it should be noted that these precedents have not dealt with the de-merger of a listed company.
- 148 The proposal in this case is to confirm that the consequences of any de-merger should be tax neutral for Telecom, ServiceTel, Chorus2 and the shareholders. This is considered the only viable option – the alternative of a potential depreciation clawback worth a suggested [redacted] in tax would be considered to unduly disadvantage Telecom and jeopardise any decision by shareholders on a de-merger.
- 149 The tax relief measures can be summarised as:
- a transferring assets and liabilities at their tax book values and with their tax history to Chorus2 on the vesting day, thus, among other things, alleviating a potential depreciation clawback;
 - b treating the transferor and transferee as the same person where appropriate for determining various tax matters e.g. some deductions, the nature of property transferred and many administrative matters;
 - c ensuring there are no tax gains/losses on the transfer of assets and shares in the new entity; and
 - d ensuring that Telecom shareholders are tax neutral when they receive the shares in the new Chorus2.

Public Works Act - transfer of ownership of land

Options analysis

- 150 Should Telecom structurally separate, and transfer the ownership of land from Telecom to Chorus2, that transfer is likely to trigger sections 40 and 41 of the Public Works Act 1981 (**PWA**) for land both acquired by the Post Office from the Crown, and also by Telecom under the State Owned Enterprises Act 1986 (**SOEA**).

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- 151 In simple terms, sections 40 and 41 of the PWA apply when land, including Maori land, is no longer required for “public work”, and section 40 sets out an offer back process, requiring that the land be offered for sale to the person (or successor) from whom it was acquired.
- 152 While Chorus2 will require the land for the same purpose as that which Telecom originally acquired it for, ServiceTel will no longer require the land for that purpose, and this is sufficient to trigger sections 40 and 41.
- 153 Telecom estimates that it may transfer up to [redacted] sites to Chorus2 which would be subject to sections 40 and 41, of which it is estimated a large proportion was acquired from private owners.
- 154 Land Information New Zealand (LINZ) carries out the offer back process, determining whether the land ought to be exempted from the process (in accordance with section 40). If the land is able to be exempted, the original owner is offered the land at current market value.
- 155 The Government has considered two main options:
- a refrain from intervening. In this case, sections 40 and 41 are likely to be triggered, commencing the offer back process that may require the land to be offered for sale to the person (or successor) from whom it was acquired; or
 - b ensure Chorus2 is in an equivalent position to that which Telecom currently is. For example, by extending the protection that Telecom originally had when it ceased being a State Owned Enterprise and became a private company. When that occurred, section 4(4) of the Finance Act 1990 provided that relevant sections of the SOEA continued to apply, ensuring that the sale of Telecom in 1990 did not trigger sections 40 and 41 of the PWA.
- 156 Two key issues arise:
- a the costs incurred by Telecom and what may be considered reasonable in the case that, in effect, a change in corporate ownership is occurring, rather than a material change in the use of the land; and
 - b the impact on the rights of land owners.
- 157 Taking the issues in turn, Telecom would be responsible for meeting LINZ’s costs, and service provider costs, in respect of the offer back process. Telecom’s estimate of the cost is within the range of [redacted] though even these estimates may not fully capture costs incurred through time delay and litigation.
- 158 It is anticipated that through the process, some of the land would be exempted. However, in cases where no exemption is granted and some of the original owners opt to buy the land, Telecom would be required to re-site in

the area to maintain their local service capability. While Telecom does not believe it is practicable to provide a reliable cost estimate across its portfolio of sites, Telecom has provided estimates of potential costs for some exchanges. Specifically, Telecom provided:

- a a high level cost range of [redacted] estimated for re-siting the Martinborough exchange, which is a medium sized rural exchange; and
- b an estimate of all-up cost of [redacted] for a significant exchange like the Mayoral Drive exchange, and Telecom believes that such costs could apply when relocating any of its most expensive [redacted] exchanges.

159 In terms of the potential impact on original landowners, it is important to recognise that, while this proposal means that the affected land will not be offered back to them by LINZ, the most probable counterfactual is that Telecom would be unlikely to structurally separate if it had to participate in that process due to the prohibitive costs. Therefore, original landowners are not realistically missing out on that opportunity.

160 Further, should there be a point where Chorus2 no longer requires the land for the purpose for which it was acquired, and similarly with land held by ServiceTel, the offer-back provisions of the PWA would apply from thereon.

Preferred option, effects and regulatory impact

161 The preferred option is to provide Chorus2 with the protection that Telecom originally had when it ceased being a State Owned Enterprise and became a private company. This will be given effect by extending section 4(4) of the Finance Act 1990 to Chorus2, and additionally, providing that transfer of land to Chorus2 does not itself affect section 24(4) of the State Owned Enterprises Act, which relates to sections 40 to 41 of the PWA.

162 This proposal fits with the objectives set out above for legislative change. It ensures both that the costs of structural separation are not prohibitive, and also, that Telecom is not penalised for separating, by providing Chorus2 with equivalent protection to that which Telecom currently holds.

Telecommunications Act 2001 – Network Operator status

Options analysis

163 Telecom currently has access to, and rights in respect of, many of its network assets through provisions in the Telecommunications Act 2001. More specifically, Telecom has rights as a network operator. Should Telecom structurally separate, Chorus2 will at that point own the majority of the relevant assets. However, under current established procedures, Chorus2 would be expected to apply for network operator status at the point at which it becomes

⁵ These costs have been provided by Telecom. They have not been independently verified, but are considered indicative.

a legal entity. This process could cause delay until that status is granted, the delay raises uncertainty.

164 In the event of any delay, Chorus2 would not have protection in relation to existing works and lines, as that protection is linked to network operator status. This would make it difficult to access assets.

165 In many cases, current owners will grant an easement in the form sought by Chorus2 for no, or minimal/nominal, rental. In this instance, delay and uncertainty leads to potential process costs. However, there is the potential scenario that some landowners may see this as an opportunity to generate revenue, given that the assets are in place and are expensive to relocate. There is also the scenario that in some cases Chorus2 may fail to negotiate equivalent or access rights, and Chorus2 would have to relocate assets onto land where the landowner is amenable both to relocation and also to providing access (and presumably pay a rental fee).

166 Given the nature of Chorus2's business, despite it being a new corporate entity, MED is satisfied that Chorus2 will meet the requisite statutory threshold for network operator status (set out in section 103 of the Telecommunications Act 2001).

167 The options in this case are:

- a to follow normal procedure that Chorus2 applies for network operator status at the point at which it becomes a legal entity; or
- b to enact a legislative provision deeming that, from the day of separation Chorus 2 is to have network operator status, which can be revoked in accordance with the provisions of the Telecommunications Act.

Preferred option, effects and regulatory impact

168 The preferred option is to enact a legislative provision so that Chorus2 has network operator status without being subject to a period of delay.

169 MED is satisfied that Chorus2 meets the requisite statutory threshold for network operator status and that such status is necessary because the size of Chorus2's network means that it would not be feasible to run the network if it did not have the rights of access that network operator status provides.

170 This proposal also satisfies the objectives set out above as it ensures both that the costs of structural separation are not prohibitive, and also that Telecom is not unduly disadvantaged for separating.

171 Indeed, it would provide Chorus2 with a status that Chorus currently exercises as part of Telecom today. Given the effect is to confer a status on Chorus2 that Chorus exercises now, MED does not consider the rights of landowners

are materially effected by legislative measures that maintain the status quo albeit with a transference of corporate form.

Lead ins

- 172 Similar principles apply under the Telecommunications Act 2001 to the issue of end user “lead ins”. A lead in is the cable that connects to customers’ premises. Telecom currently has access to the cable within the road area, but not once that cable crosses the road boundary into the customer’s land. Currently, Chorus has access to the lead ins via Telecom’s business and residential customer agreements. On structural separation, Chorus2 will not have contracts with end-users, and will not be able to use those access lead ins currently protected by customer contracts, which means that Chorus2 cannot guarantee service ability over the network (which extends to customers’ premises), or ensure that others do not use parts of Chorus2’s network (for example, ducts) without seeking prior permission.
- 173 Given that Chorus2 will not have a direct contractual relationship with the customers, it is concerned that customers may be able to argue that standard terms and conditions are not enforceable on the grounds of lack of privity.
- 174 A legislative provision is proposed to address this issue, by clarifying that, in accordance with the Contracts (Privity) Act, Chorus2 is to be treated as the beneficiary in relation to any Chorus2 Terms and Conditions (lead ins) that are included in an agreement between a retailer service provider and consumer, to which Chorus2 is not a party.
- 175 This proposal accords with the objectives in the sense that it provides greater certainty to Telecom, and potentially minimises future cost for Chorus2 by lessening the likelihood that others will challenge the standard terms and conditions on the basis of lack of privity. Further, there is no clear impact to others in the sense that the legislative provision is simply reinforcing contractual arrangements which both retail service providers and consumers are free to choose whether they sign up to.

Resource Management Act 1991 – Requiring Authority status

Options analysis

- 176 Telecom is currently a requiring authority under the Resource Management Act 1991, under which it holds a number of designations. Those designations allow Telecom to perform telecommunications activities under the relevant district plan.
- 177 On transfer of parts of the network to Chorus2, so that it might perform any necessary telecommunications activities, Chorus2 will need to become a requiring authority, and obtain the relevant designations.
- 178 As with the regulatory provisions above, obtaining transfers of the relevant designations involves the possibility of delay, as Chorus2 may apply to

become a requiring authority once it is a separate company. There is also the need for the retail arm ServiceTel to require secondary designations. Telecom has given MED a cost estimate for the process of ServiceTel being required to apply for designations as between per site.

179 Similar to above, the options are:

- a to follow normal procedure so that Chorus2 applies for requiring authority status at the point at which they are separate legal entities; or
- b deeming that:
 - i from the date of separation, Chorus2 will have requiring authority status under the Resource Management Act, in relation to both telecommunications and radiocommunications, and across New Zealand;
 - ii noting that the Minister for the Environment's power to revoke requiring authority status (section 167(5)) for Chorus2 applies;
 - iii transferring the relevant designations, which will be specified in an Order in Council, from Telecom to Chorus2, with those designations retaining the same status as they currently have; and
 - iv granting additional designations to ServiceTel, for those sites where it is necessary that Chorus2 and ServiceTel both have designations.

Preferred option, effects and regulatory impact

180 The preferred option is the latter. In recommending this, MED has assessed Chorus2 against the statutory threshold and is comfortable that, given Telecom met the requisite threshold earlier, Chorus2 now would.

181 This proposal also satisfies the objectives set out above, as it ensures both that the costs of structural separation are not prohibitive, and also that Telecom is not penalised for separating. It provides Chorus2 with the status and designations that Telecom currently holds. In respect to the secondary designations granted to ServiceTel, it is similarly replicating designations Telecom currently holds.

182 This proposal does not clearly raise wider environmental impacts given the legislative provisions are on the basis of a set of conditions, requiring Chorus 2 (and ServiceTel) to provide equivalent conditions to those that Telecom gave (e.g. the same policies and approaches in relation to environmental management and consultation). In relation to the designations, the proposal does not involve creating new designations over new pieces of land. It simply involves transferring, or creating additional designations, for land that is already subject to a designation for those activities. However, for some

landowners, their land will be subject to designations for both Chorus2 and ServiceTel (where previously only Telecom). Those landowners will therefore, have to seek consent from two companies in relation to the land.

Private access agreements

Options analysis

- 183 Telecom has many private land access contracts in the form of leases, licences and other agreements. These contracts provide Telecom with access, over private land, to buildings, cables and infrastructure owned by Telecom.
- 184 Under structural separation, if Telecom transfers particular assets to Chorus2, Chorus2 will require the access agreements to be assigned. These agreements vary in terms of assignment rights, including those assignable as of right, those that are assignable to a related company of Telecom, and those that are only assignable with the prior agreement of the counter-party.
- 185 In relation to those agreements that are only assignable with the prior agreement of the counter-party, where those agreements are leases, and provided assignment is not strictly precluded, a requirement that consent not be unreasonably withheld or delayed is read in by virtue of the Property Law Act 2007.
- 186 However, the condition that consent is not to be unreasonably withheld applies simply to leases, and does not extend to other forms of contract. Therefore, where Telecom gains access to land via licences or general access agreements, unless the agreement explicitly provides for it, the counterparty need not act reasonably in withholding consent to assignment.
- 187 Telecom estimates that it has licences that it would have to obtain assignment for, with those licences covering approximately sites. Given there is no requirement for the counter-party to act reasonably in consenting to assignment, this raises the possibility that a counter-party may see this as an opportunity to generate revenue or refuse to agree to assignment.
- 188 In terms of the potential costs of assignment, Telecom has estimated costs between
- 189 The options considered included either leaving Telecom to resolve any issues arising with the relevant landowners; or providing legislative provisions that seek to ensure that consent is not unreasonably withheld as part of the corporate transition process Telecom faces.

Preferred option, effects and regulatory impact

- 190 In relation to Telecom's land access agreements which do not prohibit assignment (other than leases, which are already provided for in the Property Law Act 2007), the following legislative provisions are proposed, providing:

- a consent to transfer or assign the agreement is not to be unreasonably withheld and, within a reasonable time:
 - i consent is to be given; or
 - ii notification in writing that consent is withheld; and
 - b a provision setting out what constitutes unreasonably withholding consent (for example, an equivalent to section 227 of the Property Law Act); and
 - c a provision providing for damages if consent is unreasonably withheld (for example, an equivalent to section 228 of the Property Law Act).
- 191 In terms of the objectives, this ensures that the costs of structural separation are not prohibitive, and also that Telecom is not penalised for separating. It provides some/limited assistance to allow Telecom to transfer the access rights it currently holds to Chorus2.
- 192 In terms of the impact on counter-parties, it does retrospectively read in a requirement that consent not be unreasonably withheld or delayed. However, this is only in relation to agreements where assignment is not prohibited. It still requires Chorus2 to obtain assignment and, provided not unreasonably withheld or delayed, consent need not be given.
- 193 MED considers that, to some extent, these measures do diminish the rights of counter-parties, but not to a significant degree, and it is proposed as a measure to equalise the bargaining position of the parties concerned.

Restrictive covenants

Options analysis

- 194 Telecom, as the owner of relevant sites, benefits from restrictive covenants that were imposed on neighbouring land when Telecom subdivided particular pieces of land.
- 195 In simple terms, the restrictive covenants provide that the neighbouring landowner agrees that Telecom has the right to carry on its business as a network operator, and discharge and emit electromagnetic fields and noise over the neighbouring land within certain parameters and levels. The neighbouring landowner also agrees not to object to the applications made (including resource consents) for specified purposes, to forego rights or remedies arising from use of the land in the terms of the covenant, not to grant a lease, licence or easement authorising operation of equipment that would cause interference, or itself operate equipment that would cause interference.
- 196 As Chorus2 is the network owner, if structural separation comes into effect, the ownership of relevant sites would be transferred to Chorus2, and the restrictive covenants will similarly transfer to Chorus2, and not ServiceTel.

This creates an issue for ServiceTel who will continue to carry out operations on some of these sites. The restrictive covenants ensure that neighbouring landowners are precluded from objecting. However, ServiceTel will no longer have the benefit of them.

- 197 This would have cost implications for ServiceTel. Telecom estimates that this issue relates to between [redacted] sites, and that the costs could range from:
- a [redacted] or a simple consent;
 - b [redacted] for a complex notified consent; and
 - c between [redacted], per site, for relocating sites where ServiceTel is unable to obtain a resource consent due to the neighbouring landowners objections.
- 198 As the neighbouring sites were subdivided from exchanges, and are therefore in close proximity to Telecom's land, Telecom considers it is likely that the consents will be costly and difficult. There is some argument that, through section 301 of the Property Law Act 2007, ServiceTel would be able to enforce the covenants. However, there is doubt as to whether Chorus2 and ServiceTel could concurrently enforce the covenant.

Preferred option, effects and regulatory impact

- 199 MED believes that the most appropriate option is to additionally grant to ServiceTel, the benefit of restrictive covenants that currently apply to Telecom as a whole. The other main option considered was not to legislate specifically, but this would not meet the objective of not unduly penalising Telecom from separating.
- 200 It is therefore proposed that a legislative provision will be provided so that: for those sites on which Chorus2 will have the benefit of restrictive covenants, but which ServiceTel will also continue to carry out activities on, ServiceTel is to jointly have the benefit of those restrictive covenants.
- 201 This proposal accords with the objectives in that it ensures both that the costs of structural separation are not prohibitive, and also that Telecom is not penalised for separating. It does not have a substantive impact on neighbouring landowners who agreed to the restrictive covenants. Therefore, while the restrictive covenants will now apply to both Chorus2 and ServiceTel, they still apply in relation to the same specified activities.
- 202 In buying land subdivided by Telecom, purchasers (and later purchasers if the land was onsold) were aware that they were buying land located next to an exchange, and that particular activities would be carried out on this land. The price of the land likely reflected those factors. This proposal simply reflects that the activities will be carried out by the landowner, and another company using the land, rather than simply the landowner.

- 215 Seeking an express authorisation through legislation in relation to the Commerce Act involves a risk in not following the established process in considering the full competition effects of an arrangement whereby Chorus2 owns both copper and fibre networks. However, there are considered to be public benefits of managing the transition between networks through such an arrangement.
- 216 With regard to changes specific to Telecom regarding the actual process of separation, the proposals have been developed with the intention of minimising unnecessary compliance costs.
- 217 A risk remains that the final split of assets and governance arrangements proposed by Telecom contain elements that could be anti-competitive in nature, and/or that despite the move to structural separation, incentives still remain and remedies are required for discriminatory behaviour. In addition, during a transitional period there will be sharing of certain assets by Chorus2 and ServiceTel, which will also need oversight. To mitigate the risks of anti-competitive outcomes:
- a a due diligence process will be established for officials and relevant experts to focus on the detail of the asset split proposals (from January-April 2011);
 - b a process will be set up in legislation whereby separation will be contingent on approval of the asset split by the Governor General by Order in Council;
 - c a set of independent oversight arrangements are proposed to provide oversight of the sharing of assets for a transitional period, including a set of transparent powers of audit and enforcement for the Government and the Commerce Commission.

MONITORING, EVALUATION AND REVIEW

- 218 The changes in this package are complex, and implementation remains dependent on Government's confidence in the final shape of separation proposals, and approval by Telecom shareholders.
- 219 MED as the policy agency, and the Commerce Commission as the telecommunications regulator have important roles to ensure the changes are implemented as planned. The Commission has a set of powers under the Telecommunications Act to monitor the level of competition in the market, and to investigate breaches.
- 220 A specific review of the Local Service TSO is set out in the proposals reporting in 2013.
- 221 Given the inherent inter-relationship between market and competition issues that relate to both copper and fibre access networks, a review is proposed of the overall framework for regulating telecommunications services in New

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Zealand commencing no later than 1 January 2018. This is timed to coincide with the conclusion of the regulatory forbearance period (that runs until 2019) as agreed under the UFB proposals.

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APPENDIX 1 – GLOSSARY OF TERMS

Act	The Telecommunications Act 2001.
Chorus2	Telecom's fixed network access business following structural separation. MED has assumed that the assets of Chorus2 will include the access network, the access network's active electronics, most exchanges and regional backhaul links.
Clothed UBA	The regulated wholesale bitstream service provided by Telecom, where the end-user also purchases a Telecom POTS telephony service.
Co-location	A wholesale service providing access seekers with co-location space in a Telecom exchange or cabinet for the purpose of installing their own equipment.
DSLAM	Digital Subscriber Line Access Multiplexer. The equipment located in either an exchange or a cabinet that enables the provision of broadband services over copper wires.
Layer 1	Normally associated with the passive infrastructure in a network, and involves providing access seekers with access to physical infrastructure such as 'dark' (unlit) fibre or copper so they can create their own network services.
Layer 2	Normally associated with the active infrastructure in a network, and involves using equipment to enable a bitstream, allowing access seekers to provide end-to-end network services over the physical infrastructure.
Local Service TSO	The series of obligations Telecom is obliged to meet under the terms of the Local Service TSO Deed, including network coverage and free local calling obligations.
Local Service TSO Deed	The TSO Deed for Local Residential Telephone Service of December 2001 between Telecom and the Government which sets out Telecom's obligations under the Local Service TSO.
Naked UBA	The regulated wholesale bitstream service provided by Telecom, where the end-user does not also purchase a Telecom POTS telephony service.
Operational separation	The restructuring of Telecom under the terms of Telecom's Separation Undertakings provided to the Minister of Communications and Information Technology on 25 March 2008.
POTS	Plain Old Telephone Service, a basic analogue telephone

service.

PSTN	The Public Switched Telephone Network, a dial-up telephone network used, or intended for use, in whole or in part, by the public for the purposes of providing telecommunication between telephone devices.
Retail minus	A pricing methodology for calculating the price of wholesale services by reference to the prevailing retail prices charged by the access provider.
ServiceTel	The remainder of Telecom's businesses following structural separation. MED has assumed that the assets of ServiceTel will include national backhaul links, the PSTN assets, mobile and retail functions.
Sub-loop UCLL	Sub-loop Unbundled Copper Local Loop service. Sub-loop UCLL is a regulated copper wholesale service that allows access seekers to attach electronic equipment to Telecom's copper sub-loops that terminate at cabinets.
Telecom's Separation Undertakings	Telecom's Separation Undertakings, as provide to the Minister for Communications and Information Technology on 25 March 2008 in accordance with section 69K(2)(c) of the Act and as varied by agreement between Telecom and the Minister for Communications and Information Technology on or before 28 May 2010 in accordance with section 69U of the Act.
TSO	Telecommunications Services Obligations, a statutory process set out at Part 3 of the Act to provide for the delivery of telecommunications services that would not otherwise be delivered on a commercial basis or at an affordable price.
UBA	Unbundled Bitstream Access. UBA is a regulated wholesale bitstream service provided by Telecom over its copper local loop network. UBA is provided both with (clothed) or without (naked) a POTS telephone service.
UCLL	Unbundled Copper Local Loop. UCLL is a regulated copper wholesale service that allows access seekers to attach their own electronic equipment to Telecom's copper local loops that run from end-users' premises to Telecom's local exchanges.
Voice Input	The narrow or low frequency band of the copper wire that is used to transmit analogue signals such as POTS telephony.

