



**Submission in response to  
Telecom's request for a fourth variation  
to the  
Operational Separation Undertakings**

**23 July 2010  
Public version (there is no confidential version)**

## Table of Contents

1.	Summary	2
2.	Accepting this variation ends operational separation	3
3.	UFB does not change the policy drivers for operational separation	4
4.	Change operational separation later?	5
5.	Variation causes substantial or fatal damage to the UFB initiative	6
6.	No cost-benefit analysis or peer review	8
7.	The lessons from XT etc	8
8.	The variation is unenforceable	8
9.	BT comparison	9
10.	Responses to specific questions	9

### I. Summary

I.1 InternetNZ is grateful for the opportunity to submit on Telecom's proposed Variation 4.

I.2 We **oppose** the proposed variation. Our reasons include:

- (a) The purpose of the variation is to effectively end operational separation. For example, Telecom's intent is to reduce the three box model (Chorus, Wholesale and Retail) down to two. This contravenes both the policy drivers and also the legislation. Such a change can only be accomplished by legislation, not via the back door of variation of the Undertakings.
- (b) UFB does not change the policy drivers for operational separation. For example, as MED notes, the copper network is a constraint on UFB pricing, and therefore regulation (including operational separation) is a key component of the UFB model.
- (c) Mass-market UFB, in particular, will not be widely available for up to 10 years. So there is an ongoing need for operational separation during the intervening period.
- (d) Whether operational separation should be removed can be considered (a) as market conditions change particularly as UFB evolves and/or (b) as part of a specific structural separation proposal (not before).
- (e) Accepting the variation will cause substantial or fatal damage to the UFB initiative. Contrary to Telecom's requirement that Variation 4 be agreed before Telecom participates further in the UFB process, the opposite is the case. Alternatively, Telecom would be in a substantially stronger negotiating position against CFH and government. That is because operational separation is driving Telecom toward structural separation and the UFB

initiative. The Minister's choice has major implications for the success or failure of UFB. To blink now is to play to Telecom's strategy, built up over a series of variations.

- (f) The proposal lacks cost benefit analysis, peer reviews, etc. There are only a series of unsubstantiated assertions. Much greater detail and independent information is essential for a change of this magnitude.
- (g) Even assuming the XT and other failures provide cause for concern, that only justifies a delay of a few months, not effective removal of operational separation.

## 2. Accepting this variation ends operational separation

- 2.1 The purpose of Telecom's proposed variation, built on a series of variations, is to end operational separation. To do that requires legislation. Accepting the variation would be *ultra vires*.
- 2.2 The policy and legislative basis of operational separation includes:
  - (a) Equivalence; and
  - (b) A three box model (Chorus, Wholesale and Retail).
- 2.3 The purpose of the requested variation is to remove the three boxes and make them into two (at best). Telecom correctly note that operational separation requires separate service stacks for Layer 1 (Chorus) and Layer 2 (Telecom Wholesale), reflecting the 3 box model.
- 2.4 The purpose of Variation 4 is to eliminate the two separate stacks and have one combined stack, in view of, claims Telecom, the combined Layer 1 and Layer 2 services provided by the LFCs. This means that the purpose of the variation is to remove the 3 box model, which has Layers 1 and 2 in different business units. The two stacks will be in one business unit (Chorus). This change is not permitted by the legislation or by sound policy.
- 2.5 Telecom's purpose is apparent from the 21 May Variation proposal:

*Where an LFC is delivering layer 1 and 2 services, it seems equally clear that these would be best delivered over a single service stack. This development requires us to revisit some fundamental premises behind Telecom Wholesale's FMO strategy. Our current path would lock the industry into separate and different service stacks for layer 1 and layer 2 services (whether or not a separated Telecom is the LFC or a customer of the LFC).<sup>1</sup>*

*Continuing to develop separate Telecom Wholesale and Chorus FMO system stacks when we know the desirable starting position for UFB is a single set of*

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<sup>1</sup> Page 3 Variation 4 proposal

*systems simply creates risks for Telecom and the industry. It takes us backward, not forward.<sup>2</sup>*

*The underlying business architectures being implemented in the Wholesale and Chorus Transformation Programmes reflect a three box organisational model, with EOI integration a requirement between the two architectures....*

*In a UFB world, where the industry is re-aligned to a two box model, all of this would need to be revisited and re-designed in order to consolidate the mirrored architectures into one. This would particularly be the case were Telecom to proceed with a structural separation, and would mean that any LFC formed by the Government with Telecom (or a structurally separated off-shoot) would spend much of its early years distracted by having to invest in this complex exercise.<sup>3</sup>*

- 2.6 The purpose of the variation is clear: to effectively eliminate operational separation in practice (and eliminate it legally too).
- 2.7 Operational separation is a composite solution in which each part plays its role. Remove one part and the carefully integrated whole collapses. Removing separation of Layer 1 (Chorus) from Layer 2 (Wholesale) is a change of that scale.

## **EOI**

- 2.8 Additionally, Telecom claim and also imply that EOI remains under their proposal. It does not. There is EOO at best, with substantial questions, not answered in the proposal, as to the level of equivalence. EOI is a well established policy mechanism, and Telecom is seeking to erode it. From past experience, and also earlier submissions, it appears that Telecom is not delivering equivalence, contrary to its claims.

## **3. UFB does not change the policy drivers for operational separation**

### **3.1 The UFB initiative requires:**

- (a) a focus on large business, schools and hospitals in the first 5 years; and
- (b) roll-out to the mass-market (predominantly residential) within 10 years.

### **3.2 This means that mass-market roll out can be expected nearer the end of the 10 year period.**

### **3.3 For most or all of that 10 year period, copper-based services such as UBA and LLU will remain important for both Telecom and for access seekers. Indeed, Government is specifically relying on the competitive constraints imposed by the**

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<sup>2</sup> Page 14 Variation 4 proposal

<sup>3</sup> Page 15 Variation 4 proposal

copper network, to restrain UFB pricing.<sup>4</sup> This indicates there should be no let-up on Telecom's regulatory obligations as to copper-based access services.

- 3.4 Further, UFB will not be a wide spread reality for at least another 5 to 10 years. Until then, the copper network presents the same challenges underlying the move to operational separation back in 2006. If Telecom is not required to follow its operational separation commitments, competition diminishes, as access seekers fail to get access on EOI terms via the three separate Telecom business units.
- 3.5 As part of its series of variations, each building carefully on the other, Telecom has already managed to push out EOI obligations by 2 years (in addition to tradeoffs initially agreed in the undertakings).
- 3.6 As the Commerce Commission has correctly noted:<sup>5</sup>

*The Commission considers that similar Telecom requests for variations that would result in delays are likely for the same reasons (that is, uncertainty as to the future will likely be a component affecting all telecommunications service providers for years to come). The modest benefit to Telecom from these delays does not justify subordinating the interests of other service providers in Telecom fulfilling its freely given commitments, particularly where delays may have a material impact on competition.*

#### **4. Change operational separation later?**

- 4.1 Continuation of operational separation in the medium term does not rule out substantial variation or even removal of operational separation later. This will probably require legislation (as that outcome cannot be achieved by variations).
- 4.2 For example:
  - (a) If Telecom structurally separates, part of the changes can include removal or substantial variation of the operational separation undertakings. This is an issue for structural separation negotiation and agreement, not for agreement while structural separation is still only being "considered".
  - (b) As evidence of a competitive market is clearly demonstrated (particularly as mass market FTTP becomes available), the undertakings can be substantially varied or removed.
- 4.3 That this variation should be considered only after or as part of a specific structural separation proposal, not before, is further highlighted below.

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<sup>4</sup> Para 28, MED's overview of ITP amendments 8 July 2010

<sup>5</sup> Letter Commission to MED of 15 March 2010

## 5. Variation causes substantial or fatal damage to the UFB initiative

- 5.1 Telecom says it will not participate in the UFB process if the variation is not approved. It is likely however that either (a) the opposite is the case (Telecom is less likely to participate) or (b) agreeing to the variation will lead to poor UFB outcomes due to Telecom's resulting stronger negotiating position. In particular, structural separation is significantly less likely, and therefore participation in the UFB is less likely, if the proposed variation is accepted.
- 5.2 Additionally, Telecom will be in a much stronger position to negotiate favourably against CFH and Government if this variation is agreed.
- 5.3 These are appropriate issues to take into account, including because, by its series of coordinated variations, Telecom has manoeuvred to this position. Ultimately, much of the underlying Telecom strategy appears aimed at pushing its negotiating strength as against Government and CFH.
- 5.4 Telecom notes that it is "considering" structural separation. Those words are carefully chosen: Telecom has not made any greater commitment than this. Structural separation is complex with many stages. Its pursuit could be stopped by Telecom at any time.
- 5.5 Apart from its operational separation commitments, there is little or no incentive to structurally separate:
- (a) The true cost of structural separation (including long term cost such as lost benefits of vertical integration and the financial benefits of structural separation) is substantially more than the UFB's \$1.35Bn. In turn, \$1.35Bn is a relatively small part of the cost of an FTTP roll-out. This raises the question as to why Telecom would structurally separate (at a cost greater than \$1.35Bn) in order to run the UFB network within restraints not only as to structural separation but also open access and other LFC obligations.
  - (b) All things being equal, Telecom would be better off going it alone, particularly as:
    - (i) Telecom has a VDSL network covering 84% of the population compared to the 75% UFB footprint. That extra 9% coverage is significant.
    - (ii) VDSL speeds will meet currently known demands for speed for some years: in the short term therefore, VDSL is highly competitive with FTTP.
    - (iii) Telecom has a large established presence and customer base.
    - (iv) Telecom can build its own FTTP network, build out to only certain areas and/or make cherry-picking use of the UFB network to infill its own network.

- (v) Telecom has little incentive to build out FTTP in the next few years given (a) its VDSL network and (b) its understandable desire to sweat the use of the copper as long as possible.
- (vi) Confronted with Telecom's strength as outlined above, the other UFB bidders have a substantially weaker or even fatal business case. Would a financier back another bidder against the Telecom strength, faced with the advantages that Telecom has (including the fact that Telecom has no obligation to migrate its customer base to the UFB network)?
- (c) All that leads to a strong negotiating position for Telecom. All things being equal, they would not participate in UFB.
- (d) This indicates that something else is driving Telecom to consider (and potentially implement) structural separation. That will be – balancing all factors - the constraints on Telecom by reason of operational separation. As Telecom is subject to operational separation, it might as well structurally separate. The counterfactual for Telecom is an operationally separated Telecom: this is a particularly significant point. If Telecom was not operationally separated, it is hard to see why it would participate in UFB (unless on terms highly favourable to it). Take away operational separation and Telecom has little or no incentive to structurally separate or participate in UFB.
- (e) The proposed variation – one of a series – will effectively remove operational separation.
- (f) Telecom has reached this position by a series of carefully coordinated variations, each ratcheting up the position relative to the prior variations. This strategy is producing outcomes favourable to Telecom and adverse to access seekers and end users.
- (g) Against that background, Telecom says it will not participate in UFB unless the variation is accepted. The opposite is the case. (Alternatively, accepting Variation 4 puts Telecom in a much stronger negotiating position against CFH and Government).
- (h) For this reason alone, the Minister's choice has major implications for the success or failure of UFB. To blink now is to play to Telecom's strategy.
- (i) There is no need for this variation to be a precursor to structural separation and participation in UFB. The variation or something similar can be part of the package put forward to government. For example, the structural separation package could include terms that operational separation is removed by legislation. Telecom's approach, in saying that it will only participate in UFB if the variation is approved, makes clear that the company is engaged in regulatory gamesmanship.

## **6. No cost-benefit analysis or peer review**

- 6.1 Telecom provides scant data as to why it is challenged in meeting the promises it made (and some of those promises were made to buy more time). For example there is no data about the incremental cost of continuing to EOI for BUBA, EUBA, and LLU, compared with the benefits for end users. Such verifiable justification is needed for such a major departure from the undertakings (which, as noted above, would effectively eliminate operational separation). Noteworthy is that, in relation to one of its previous variation requests, a peer review report was provided. There is nothing here.
- 6.2 We submit that the Minister should reject this request for variation based on these and other submissions. But if the request is to be further considered, independent and reliable analysis by professionals, including engineers and economists, should be provided by Telecom, at its expense, for review by stakeholders, MED, the Minister, the Commission and the IOG.
- 6.3 We note the various submissions already made that these issues are matters for monitoring, review and enforcement by the IOG and the Commission. The Commission has the ability to recommend a variation. Importantly there is the ability to excuse a breach of the undertakings due to unforeseen circumstances etc.
- 6.4 This path should be followed. It will enable fully informed decision making, and not decision-making based on limited assertion and limited analysis by Telecom.
- 6.5 In the meantime, Telecom should proceed as though it must meet its current timeline commitments.

## **7. The lessons from XT etc**

- 7.1 Telecom makes much of this. It is ironic, and concerning, that Telecom's failures should be called in aid of a change of its promises. Rather, the position is that Telecom should have learned from those mistakes, to ensure problems don't arise in the future.
- 7.2 However, even if this is a valid concern, it does not justify the proposed variation which effectively stops operational separation. For the reasons noted above, such issues only justify a short delay (say 3 months) so that risk is minimised. If there is demonstrable evidence of real risk, contrary to all the assurances earlier given, InternetNZ would support a short delay of say 3 months.

## **8. The variation is unenforceable**

- 8.1 Most requested changes substitute "A date agreed between the Minister and Telecom", in place of a milestone date.

8.2 Both parties have to agree that date. Otherwise, Telecom can just refuse to agree, thereby removing all compliance obligations.

## 9. BT comparison

9.1 The larger number of BT variations (said to indicate that Telecom's variations are minimal) are, collectively, nowhere near the size of the combined effect of Telecom's variations. In any event, the circumstances are quite different.

## 10. Responses to specific questions

### Wholesale Broadband Service Migration

Do you agree that the Undertakings requirement to migrate 90% of broadband customers being served by the old wholesale broadband service onto the new wholesale broadband service by 31 December 2010 should be suspended?

10.1 No, for the reasons noted above.

Do you agree that the Undertakings requirement to migrate 100% of broadband customers being served by the old wholesale broadband service onto the new wholesale broadband service by 31 December 2011 should also be paused, pending agreement of a new migration plan in the context of the UFB process?

10.2 No, for the reasons noted above.

### Wholesale Future Mode of Operation (FMO) Systems

Do you agree that the Undertakings requirement to build a new set of wholesale operational support systems (i.e. the FMO systems) should be removed where they are not consistent with the industry structure implied by UFB?

10.3 No, for the reasons noted above.

Do you agree with Telecom's claim that Wholesale FMO systems are not needed to deliver EOI for the relevant services? Please provide your reasons.

10.4 No, for the reasons noted above. At best, only Equivalence of Outcomes would be possible, and true EOO is an unlikely outcome. We understand that access seekers consider there would not be EOO. Further, the fact that Telecom claim Wholesale FMO systems can deliver EOI, when in fact they can't, demonstrates why the systems are required. EOI is designed to overcome that sort of unsupportable claim made by access providers.

If the Undertakings were amended to remove wholesale FMO systems requirements that are not consistent with the industry structure implied by UFB, in your view would it be necessary to require Telecom to address any specific issues with affected telecommunications service providers to ensure that relevant EOI requirements are met? If so what specific EOI issues and why?

10.5 First, the operational separation and UFB structures are consistent as outlined above.

10.6 If however, there is to be change, the structure must contain genuine EOI, as defined in the undertakings, a transition to that EOI-based model over the same or similar timelines as currently required, and an overall structure (whether operational or structural separation) which deals with all required aspects including behavioural and EOI. See our reasons above. This can only be achieved after careful consideration and within the context of a wider solution: in particular, Variation 4 must not be permitted prior to and separate from that solution, for the reasons noted above.

InternetNZ is very happy to provide more detail or background information on this matter to officials or Ministers, if that would assist with their consideration of this variation request.

With many thanks for your consideration,



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