

**COMMENT ON THE NZIER REPORT 'TELECOMMUNICATIONS
PRICING IN NEW ZEALAND: A COMPARISON WITH OECD
COUNTRIES'**

For:

**THE NEW ZEALAND MINISTRY OF ECONOMIC
DEVELOPMENT**

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Table of Contents

1	INTRODUCTION	1
1.1	The MED Report.....	1
1.2	The OECD/Teligen Methodology.....	2
1.3	NZIER Report.....	2
2	NZIER’S ISSUES WITH THE OECD BENCHMARKING MODEL.....	3
2.1	New Zealand’s Customer Profile is Different	4
2.2	New Zealand’s Price Caps Need to be Taken Into Account.....	7
2.3	The Most Recent, Updated Tariffs Should be Used	8
2.4	Issues with PPP and Monetary Exchange Rates are Affecting Results	9
3	Conclusions.....	10
	<i>Table 1: Comparing OECD vs. NZIER Rankings.....</i>	<i>3</i>

1 INTRODUCTION

This document has been prepared as a response to the NZIER report *Telecommunications Pricing in New Zealand: A Comparison with OECD Countries* (the NZIER report) which was produced for Telecom New Zealand in May 2005.

The NZIER report is a response to New Zealand's Ministry of Economic Development (MED) report *Benchmarking the Comparative Performance of New Zealand's Telecommunications Regime* (the MED report), published in June 2004.

In early July 2005, Argo TMC was asked by the MED to comment on the NZIER report. We have based this report on our analysis of the NZIER document, our recent experience of the New Zealand market, and the ranking methodology used by the OECD to rank the 30 OECD countries for telecom tariffs. The OECD model is updated and sold by Teligen, a private company, using the methodology approved by the OECD.

It is important to note that we did not access the latest OECD/Teligen model to re-examine the conclusions that are published in the MED report or to test any new modeling scenarios.

Overall, we believe that the changes proposed by NZIER do not warrant being included in a revised model. Several of the proposed changes would disproportionately favour New Zealand over other OECD countries and appear to go against the purpose of devising an international benchmark. While there can be debate about the inclusion or exclusion of particular discount plans, or the methods used to calculate exchange rates, we believe that the OECD/Teligen methodology used to produce the rankings in the MED report remains sound.

1.1 The MED Report

The MED report examined the state of New Zealand's fixed-line, cellular and broadband markets by:

“assess(ing) the comparative performance of the New Zealand telecommunications regime in respect of the prices for key telecommunications services and the uptake of key new services.

Comparative performance (was) assessed by benchmarking prices with other OECD countries. The limitations of the benchmarking methodologies (were) taken into account in drawing conclusions.”

The results of this survey were not positive: New Zealand consistently ranked in the lower half of the OECD rankings. In the fixed-line market, New Zealand ranked 23rd out of 30 OECD countries for residential customers and 22nd out of 30 OECD countries for

business customers.

Several parties have criticized the OECD/Teligen methodology and its applicability to the New Zealand market.

1.2 The OECD/Teligen Methodology

The data and results for the MED report were derived from a quarterly publication produced by the OECD in conjunction with the consultancy Teligen. Teligen states that “The OECD methodologies are developed by OECD through field research across all OECD countries, and have been accepted in most countries as the most stable and neutral method of comparison.”

The OECD developed the basket methodology for tariff comparisons in the late 1980s, principally for Public Switched Telecommunications Networks (PSTN). It did so because of dissatisfaction with the then existing methodologies. Among the difficulties then were that some methodologies used baskets based on data from a single country where the data itself could be challenged as being out of date; and that no distinction was made between business and residential users.

The central idea of the OECD methodology was, and is, that for meaningful international tariff comparisons it is essential to compare the tariffs on the basis of representative consumption baskets. It was understood right from the outset that these representative baskets might not accurately represent any particular OECD member, but that was not the purpose. The intention was that the baskets would allow a comparison between two countries even if one had high fixed charges and low usage charges and another country had the opposite tariff structure.

1.3 NZIER Report

The NZIER report raises a number of issues with the OECD/Teligen methodology which, it argues, adversely affect the overall ranking of New Zealand in the group of 30 OECD countries. In summary, these are:

- 1) The New Zealand customer profile is different to that assumed in the OECD model
- 2) New Zealand call price caps need to be taken into account
- 3) The most recent, updated tariffs should be used
- 4) Issues with PPP and monetary exchange rates are affecting results

NZIER argues that these issues should be corrected to better represent New Zealand’s true OECD ranking. In the report they state:

“Applying New Zealand’s unique customer calling profiles to OECD price regimes (Teligen™ November 2004) and using Telecom’s November 2004 tariffs we find that New Zealand’s customers have telephone price regimes which are less expensive relative to most other OECD telecommunication companies.”

By applying these changes New Zealand’s ranking changes as shown in the table below:

Table 1: Comparing OECD vs. NZIER Rankings

	OECD	NZIER		
		Using PPP	Using monetary exchange rate	Updated PPP
Residential	23	11	2	9
Business	22	19	8	16

Clearly there are significant improvements by using NZIER’s methodology. However, as will be discussed below, we believe that many of these changes in methodology do not stand up to critical analysis and, keeping in mind the purpose behind this type of benchmarking, should not be applied in this or any other similar case.

2 NZIER’S ISSUES WITH THE OECD BENCHMARKING MODEL

In its report to Telecom New Zealand, NZIER states:

“Most benchmarking is inherently subject to sensitivity around the assumptions used. The assumptions in the MED report need to be reviewed and considered in a New Zealand context.”

We agree that benchmarking telecom services is extremely sensitive to the nature of the assumptions used. Decisions made when designing the benchmark regarding service elements, pricing, exchange rates, calling patterns, discounts, etc., will have a far-reaching effect as they cascade through the modelling process and influence the eventual outcome.

Inherent in the design of a benchmark is the requirement to develop a set of standards that do not overly-favour any particular element that is being measured. While an "average" basket of telecom services will not match the reality on any given country, the intention is to create a standard tool of measurement that can accurately assess prices across a wide range of countries and or telecom operators.

As mentioned in the introduction above, NZIER's report discusses several issues that it believes adversely affect New Zealand's overall OECD ranking. These issues can be summarized into four categories:

- 1) **The New Zealand customer profile is different.** New Zealand customers have specific calling patterns that are different from the OECD/Teligen model and these should be accounted for.
- 2) **New Zealand call price caps need to be taken into account.** New Zealand Telecom offers a price cap on calls between 15 minutes and 2 hours that can lower the cost of a consumer's telecom bill. This price cap should be included.
- 3) **The most recent, updated tariffs should be used.** Since the publication of the report, changes have occurred to New Zealand Telecom's tariffs. The model should be revised taking into account these latest tariffs.
- 4) **Issues with PPP and monetary exchange rates are affecting results.** The PPP exchange rate used in the OECD/Teligen methodology is overvalued compared to the monetary exchange rate. The model should be revised using different exchange rates.

Following below is our analysis of each of these four issues and our opinion as to whether the changes proposed by NZIER are appropriate and should be incorporated into a revised OECD/Teligen model.

2.1 New Zealand's Customer Profile is Different

The NZIER report claims that the calling patterns of New Zealand customers differ from other countries. Specifically it details three factors that differ from the OECD basket:

1. Peak load calling patterns. Of their weekly calls, New Zealand customers make approximately 5% more during peak hours, 12% more during off peak hours and 23% fewer during weekends than the OECD basket.
2. Local & national (long distance) zones. New Zealand has one of the largest local calling zones in the OECD (40km). As a result, New Zealand customers make approximately 17% more calls to local numbers and 30% fewer calls to national numbers than the OECD basket. This translates into 5% more local call minutes and 34% more national call minutes per annum than the OECD basket
3. International calls. New Zealand customers make significantly fewer international calls per annum (15 as opposed to 72 in the OECD basket) yet they consume only 13% fewer international minutes (218 as opposed to 252 minutes in the OECD basket). As a result, the minutes per call for international calls from New Zealand are much greater (15 minutes per call as

opposed to the OECD basket average of 3.5 minutes per call).

It is beyond the scope of this document to re-run the OECD/Teligen model using the exact calling patterns of New Zealand customers. While it is evident that some of the elements of New Zealand calling patterns are likely to be more expensive, in some cases the inverse also appears to be true: several of these New Zealand specific differences can lead to lower prices being paid by New Zealand consumers (e.g. more off-peak hours calls, a large local calling area).

Customers in a given country tend to follow a rational economic practice and use the telephone in ways that to some degree reflect tariff structures in their territory. If certain services are expensive, they are likely to use them less than their counterparts in other countries. Likewise, if certain services are offered at extremely attractive prices, they may use them more. As NZIER states:

“New Zealand’s average residential customer profile reflects the nature of New Zealand’s telephone price regime. New Zealand residential customers have no peak rate charges, and free and wide local calling areas. New Zealand customers will therefore make more calls during times and over distances where customers in other OECD countries are paying higher tariffs”

As the opposite is also true (customers in other countries will make calls at times and to destinations that would be more expensive in New Zealand), it is unreasonable to expect a basket of services to be able to accommodate all countries optimal usage patterns.

The OECD recognises the issue of favouring one particular country when designing benchmarks. In section 2.3 of their initial publication¹ which set out the goals and methodology for international benchmarking, they conducted a thorough evaluation of 6 previous telecom basket research studies. As they observe:

“Most of the studies are based on conceptions of average usage patterns derived only from the home country. This can lead to distortions because usage patterns inevitably reflect the existing tariff structure. This goes some way to explaining the observed phenomenon that the home country often appears favourably in international comparisons (see discussion in McDowall and Horton & Donovan, 1987). The study by McDowall (1987) develops a call distribution matrix which is based on data from a number of different countries and is therefore the closest to an “international” basket.

As Telecom New Zealand offers a discount to customers on longer calls (between 15 minutes and 2 hours) it is valid to question whether the call lengths in the OECD basket are appropriate. In their creation of the benchmarks, after closely examining the various differences between OECD member countries for fixed, charges, call durations and

¹ “Performance Indicators for Public Telecommunications Operators”, available at http://www.oecd.org/document/33/0,2340,en_2649_34223_1911713_1_1_1_1,00.html

distances etc, the OECD concludes:

“The harmonised methodology should reflect national differences in the treatment of duration, distance and time of day/week in a matter which is unbiased and neutral; that is not tied to the tariff structures of any single country”

Given the significant amount of initial research that went into this methodology, the acceptance of the OECD benchmarking methodology by the OECD member countries and its continual revision and refinement, we believe that OECD/Teligen’s approach to basket composition with respect to number of calls, duration, geographic distribution etc. is reasonable and continues to be a sound approach.

We do not believe it is appropriate to use the actual usage data for one country to compare that country with others and that a generalised ‘basket’ is an appropriate tool to test overall costs. Adjusting a benchmark for every possible national difference will result in a model that is completely inconsistent across countries and becomes unworkable as a tool for comparing broadly equivalent ‘baskets’ of telecom services.

An international comparison of telecom prices cannot be based on the observed usage in only one of the countries to be compared. For example, it is no more valid to use the usage patterns of New Zealand than it would be to use patterns from Denmark or Turkey in New Zealand. International comparisons must be based on a common basket or set of baskets that broadly reflect, as far as possible, usage across all countries yet are not specific to any one particular country.

We believe that the OECD/Teligen basket of telecom services represents a reasonable compromise for all countries with cost elements of access, local, national, fixed to mobile and international calls factored into the basket. While the exact proportions of these elements will, of course, vary from country to country, drastically changing the proportions or worse, omitting one or more of these elements will invalidate the basket approach.

Additionally, the NZIER report claims that New Zealand’s local calling zone is 40km and that the OECD benchmarking does not take this into account. There is no substantiation of this point in the report and no critical analysis offered of the actual calling boundaries, or the number of subscribers reachable within these boundaries. It is understood that there are indeed some few local calling zones in New Zealand of this size; however it is unrealistic to extrapolate an assertion that all local calling zones are 40km. In practice NZ has a range of local calling zones some of which are very large and many of which are significantly smaller than 40km.

Further, the NZIER report raises an issue regarding the benchmarking of international calls; however, it omits to specifically mention that the 2004 MED benchmark report that NZIER refers to did not benchmark international call prices. A valid explanation for excluding such a comparison is that New Zealand is remote from most other OECD countries and therefore not suitable for comparison with these countries due to the widely

varying dimensions of volume of calls and distance. Accordingly, the OECD methodology is better suited to comparing countries that have similar spatial and call volume relationships.

2.2 New Zealand's Price Caps Need to be Taken Into Account

NZIER highlights the fact that the OECD/Teligen model does not take into account New Zealand price caps that apply to national calls between 15 minutes and 2 hours duration. Although including this price cap in the OECD/Teligen model could possibly reduce the total cost to New Zealand customers (and improve New Zealand's overall OECD ranking) we believe there are a number of issues that remain to be addressed.

1. The discrepancy between the Telecom New Zealand's standard 18 cents per minute versus the average 14 cents per minute (based on Telecom billing data) is assumed to be due to the 'Anytime' plan discount. However, within the NZIER report, there is no clear explanation for this discrepancy. We believe that other factors (such as special time-limited discounts and promotions) could also account for this difference.
2. Basing average customer expenditure on data derived from Telecom New Zealand's own billing data will definitely bias any international comparisons in New Zealand's favour based on the reasoning discussed in Section 2.1 above.
3. The current Anytime plan from Telecom New Zealand is not a standard pricing feature, rather it is a specific discount plan that consumers must subscribe to. From our understanding of the OECD/Teligen methodology, the OECD baskets attempt to include many different alternative combinations of price plan and options. However, as already raised earlier in this document, is not feasible to include every possible combination of discount plan and tariff option for each country.
4. If the Telecom Anytime bundle was to be included, in order to ensure that the OECD benchmark would be measuring a comparable bundle of services across the other 29 OECD countries a number of other discount plans and special tariffs would also have to be incorporated. As the NZIER report points out, a number of tariff options in other countries are specifically excluded, including high-usage credits, no timed charges during an initial 'flag fall' period and minimum call charges that include a period of call time.

In our discussions with Teligen, they have revealed that there has been a significant dialogue between Telecom New Zealand and Teligen regarding the inclusion of the Anytime plan in their future rankings. Telecom New Zealand has updated the information they make available to Teligen and since April 2005 the Telecom New Zealand Anytime plan *has* been included in calculating New Zealand's overall ranking. In this respect, we

believe that New Zealand's overall rankings will reflect this in the latest versions of the OECD/Teligen model.

Teligen has accepted that the Anytime plan is a very common component of residential customer's basic telephone services and can be considered a 'standard' pricing feature. Furthermore, after meetings in Rome in June 2005 that were held to refine and improve the OECD's methodology, we understand that upcoming changes to the OECD baskets will include operator's discount plans to better reflect the true costs to consumers.

2.3 The Most Recent, Updated Tariffs Should be Used

From the initial February 2004 OECD data (which was collected in November 2003), NZIER revisited the OECD/Teligen benchmarks with updated New Zealand and other OECD country tariffs, using November 2004 data. Using this more recent data (along with the other changes discussed in this document) helped to improve New Zealand's overall OECD ranking.

While we do not dispute the assertion that New Zealand's tariffs may well have dropped between February and November 2004, this price reduction will only have a material effect if New Zealand's tariffs fall at a greater rate relative to the other 29 OECD countries.

Previous work we have conducted in the New Zealand mobile market has shown that while New Zealand mobile tariffs have been falling roughly in line with OECD averages, they are still among the highest tariffs in relative terms and therefore the tariff decreases do not necessarily significantly improve New Zealand's overall rankings. It is likely that the same general trend would be true in the fixed-line sector; however, the scope of this document does not support a study to determine this.

Beyond this concern about the latest tariff declines, it is important to point out that it is clearly apparent that a benchmarking study such as this can only create a "snapshot" in time. As with any rapidly changing market, the consequence is that by the time the benchmarking analysis has been performed, the results are out of date, especially given the scale and scope of the OECD benchmarking methodology. This does not, however, invalidate the exercise of benchmarking nor mean that the data is wrong, especially when the process is carried out at regular intervals.

It would be a useful exercise to conduct a historical analysis of New Zealand's rankings over time to ascertain to what extent its low rankings are a persistent feature. If it were found that New Zealand has received poor rankings consistently over time, then it is less likely in our view that incorporating the latest tariffs would make any significant difference to the rankings, unless the tariffs have fallen dramatically.

2.4 Issues with PPP and Monetary Exchange Rates are Affecting Results

In comparing prices between two countries, the two primary methods that are used are Purchasing Power Parity (PPP) and Monetary Exchange Rates. There are a number of different opinions on the applicability of each method and Telecom New Zealand has previously questioned the conversion rates used to calculate OECD PPP in the OECD model.

“Telecom also considers that the OECD Purchasing Power Parity (PPP) conversion rate applied by the MED is likely to result in the systematic overestimation of prices in New Zealand relative to the rest of the OECD.”

TCNZ, Submission in respect of the Commerce Commission’s Draft Report for its Schedule 3 Investigation into Regulation of Mobile Termination, P. 50

There have been calls to discontinue the use of PPP in certain price comparisons and it is true that in some ways, PPP is an imprecise tool. Telecom services cannot be traded across borders as PPP theory demands. Yet there are a number of reasons why PPP comparisons remain a useful tool. These include:

- The availability of broadly accepted data
- PPP better reflects consumer prices and expenditures
- PPP is insulated from rapid currency shifts
- PPP better reflects costs of living
- PPP is available for individual products, product groups and at various levels of aggregation up to and including GDP.

Although the PPP rates used by Teligen are well suited to residential telephone services as they specifically relate to consumer goods and services, NZIER supports Telecom New Zealand’s assertion that the PPP rate used in the OECD/Teligen model has been consistently above the ten-year average monetary exchange rate and illustrated this disparity with Figure 6 in their report. While we agree PPP rates have been unfavourable relative to monetary exchange rates, it is important to note that this has occurred in 20 out of the 30 OECD countries.

Following the adage that ‘a rising tide lifts all boats’, a quick re-ranking of the 30 OECD countries based on the percent discount illustrated in Figure 6 of the NZIER report shows that New Zealand’s overall ranking would only improve from 23rd place to 19th place.

We also note that there is limited information in the NZIER report as to what exact PPP exchange rates were used and how they compare to the rates used in the OECD/Teligen report. Apart from stating that “Figure 9 presents the results of benchmarking international telephone prices *using what we believe are the correct OECD purchasing power parity rates.*” (emphasis added), there is little detail as to what rate was used and how it was calculated. Did NZIER use a consumer goods PPP rate or New Zealand’s

national gross domestic product PPP rate? Without this information it is difficult to verify the accuracy of NZIER's recalculations

Despite the advantages of using PPP as a tool for international price comparisons, the New Zealand Commerce Commission published a report in September 2002 (International Benchmarking Report: A Comparative Review of Interconnection Pricing), discussing the issue of currency conversions. While agreeing that there are a number of advantages to using PPP-based calculations, they also highlighted issues with New Zealand's "persistently high current account deficits":

"An important drawback of the PPP model is that it does not appear to pick up important real influences on the exchange rate over the medium term. While PPP is useful in explaining long-run exchange rate trends, other factors appear to drive movements in exchange rates around that trend".

Commerce Commission, *International Benchmarking Report: A Comparative Review of Interconnection Pricing*, P. 38

Consequently, the Commission decided that a PPP conversion rate did not provide the most appropriate currency conversion rate for that benchmarking study and, by implication, future ones. Instead, the Commission has turned to using a ten-year historical average of currency exchange rates to calculate currency conversions.

While we recognise the imprecise nature of PPP rates, it should be remembered that the 1990 OECD principles to measure PSTN comparisons were accepted by the OECD member countries themselves (including the agreement that PPP is the preferred method for comparisons). Despite the current controversy surrounding PPP versus exchange rates, this acceptance by the OECD member countries suggests to us that it is still a useful tool for comparison and is relevant in this case.

3 CONCLUSIONS

In general we believe that the MED report, using data based on the OECD/Teligen benchmarking methodology remains a valid comparison based on sound principles. We do not believe that all of the changes proposed by NZIER can be supported in an international comparison, as they will disproportionately favour New Zealand at the expense of other countries.

Accordingly, we believe that several of points made in the NZIER report's executive summary require clarification and can be refuted.

The third bullet point in the NZIER report states:

"Most benchmarking is inherently subject to sensitivity around the

assumptions used. The assumptions in the MED report need to be reviewed and considered in a New Zealand context”

It should be noted that the assumptions and methodology used in the MED report are directly from the OECD/Teligen methodology. Any unilateral attempt to adjust the model to reflect the specific “context” of any one country as suggested by NZIER would be inappropriate and seriously compromise the validity of any subsequent findings. Accordingly, we believe the OECD/Teligen methodology to be sound.

The fourth bullet point in the NZIER executive summary states:

“New Zealand’s customer profile for telephone usage is unique and differs from the standard customer profile used by the OECD.”

Although NZIER did note differences with the OECD/Teligen basket, the authors failed to present specific information on other countries calling patterns and did not detail any specific New Zealand differences with other countries. No details were provided that detail how these differences negatively affect New Zealand vis-à-vis other OECD countries.

We are surprised that one of the significant costs to New Zealand consumers (as compared to the other OECD countries) not mentioned in the NZIER report is the cost of calls from fixed-line to mobile numbers as was specifically mentioned in the MED report (Commerce Commission, *International Benchmarking Report: A Comparative Review of Interconnection Pricing*, P. 38 Key Points #12). Although New Zealand’s total number of calls and total minutes closely match the OECD basket, the MED report highlights the high price of these calls relative to the other OECD countries, ranking New Zealand 27th for residential customers and 22nd for business customers out of the 30 OECD countries.

Further, the sixth bullet point in the NZIER report states:

“Applying New Zealand’s unique customer calling profiles to OECD price regimes (Teligen November 2004) and using Telecom’s November 2004 tariffs we find that New Zealand’s customers have telephone price regimes which are less expensive relative to most other OECD telecommunication companies.”

We believe that NZIER’s revision of the model is flawed in several areas and cannot support the conclusion that New Zealand’s telephone pricing is less expensive relative to other OECD countries. Updating the revised model with current New Zealand data while not updating the data from other countries is inappropriate. It assumes no movement in the prices in those countries and accordingly negates the validity of any subsequent findings.

Concluding with the seventh bullet point in the NZIER report:

“New Zealand’s ranking among OECD countries for telephone tariffs

improved significantly compared against MED's findings as a result of applying:

- Correct and up-to-date prices for New Zealand
- Capped calling rates for national telephone calls; and
- New Zealand's specific customer calling profile"

The first point suggests that The OECD/Teligen methodology used incorrect and outdated information in their June 2004 report. As detailed in Section 2.3 we do not believe this to be true as the OECD/Teligen applied the *most recent* data available at that time (February 2004). We also question the PPP rates used in the revised NZIER calculations as several important details relating to the type and rate of PPP formula used were omitted from the NZIER report.

Regarding the second point, as we have further detailed in Section 2.2 of this document, we believe that the OECD/Teligen was *correct* in disregarding New Zealand Telecom's capped national rates based on information provided to Teligen at that time.

From our July 2005 discussions with Teligen and given the recent moves by the OECD and Teligen to update the composition of their telecom baskets we concede that the inclusion of New Zealand Telecom's Anytime discount plan may be appropriate only if other operators' discount plans will be incorporated in the baskets and a revision of how the baskets are composed is undertaken.

The third point above encourages the use of New Zealand specific customer calling profiles. As discussed in Section 2.1 of this document, we believe that the OECD/Teligen was correct in continuing to rely on their country-neutral basket of telecom services and *not* specifically tailoring the model to use a New Zealand specific customer calling profile. Any adjustments designed to better reflect New Zealand calling patterns would provide biased results, proving advantageous to New Zealand and unnecessarily penalise other OECD countries resulting in an irrelevant benchmarking exercise..

In summary, we recognize that there remains opportunity for disagreement regarding the OECD/Teligen methodology. There is scope for revision of the methodology which continues to be made at forums represented by all OECD countries and operators willing to participate. Frequently re-running the model with current data from all countries remains sound practice. However, we believe that many of the changes proposed by NZIER cannot be justified. We also believe that the existing June 2004 MED report is based on sound OECD/Teligen methodologies, correct data available at the time and is a valid comparison of international telecom pricing among the OECD countries.