



**TELECOMMUNICATIONS USERS ASSOCIATION OF NZ INC  
(TUANZ)**

**Response to Minister's invitation for comment on:  
Telecom's revised draft Undertaking on Operational  
Separation**

**The Minister's amended Determination on  
Telecommunications (Operational Separation) 2007.**

25 January 2008

**INTRODUCTION**

TUANZ appreciates that Telecom has made a substantial number of improvements to its draft undertakings, including several points raised particularly by TUANZ. Many other serious concerns, raised by TUANZ in its submission of 23 November 2007, have not been addressed or explained.

Robust operational separation is a legal requirement of Telecom under the Telecommunications Act, and Telecom must either deliver this through its "voluntary" undertaking or have it imposed through a detailed determination by the Minister.

To be "robust", the operational separation set out in the voluntary undertaking must pass the test that

- employees of the separated business units will not retain significant motive and opportunity to place Telecom Group commercial performance above the commercial performance of the separated units, and
- Telecom Board and CEO will not have the opportunity to impose Group priorities on ANS or Wholesale to the detriment of opportunity for other service providers.

We consider that the revised draft undertaking fails the test on both of these criteria, and that accordingly the Minister ought not to approve it.

Consequently, we are disappointed that the Minister's Telecommunication (Operational Separation) Amendment Determination 2007 contains some provisions that we see as inconsistent with the stated purpose of Part 2A of the Telecommunications Act secure robust operational separation of Telecom. Specifically, we consider the following clauses of the Amendment Determination to be unhelpful or retrograde:

- 10 *Wholesale unit must have localized incentive arrangements*
- 14 *New Clause 99A Exception to Arms-length rules for access planners*
- 15 *New clause 106 No breach for trivial non-compliance*

As it is apparent that these clauses are in response to negotiations with Telecom, in which TUANZ was not consulted, and reflect Telecom's revised draft Undertaking, our reasons for objection are covered in our comments on Telecom's revised undertaking.

We address the deficiencies in Telecom's proposed undertakings in terms of their effect on a) motivation of employees, and b) opportunities to evade the intended outcomes of the Telecommunications Act s.69A.

## **MOTIVE**

Taken as a whole, the proposed arrangements would leave many managers and employees of ANS with ambiguous incentives, and Telecom's Wholesale Unit clearly with incentives biased toward favouring Telecom Business Units against the interests of competitive service providers. The structure and detail of the undertakings still contain many features that will motivate managers and employees of ANS and of Wholesale Unit to see their personal interests as connected to the interests of Telecom Group more than to the interests of their particular business unit.

Business behaviour incentives do not lie solely in annual remuneration arrangements, but also include the long-term interests of employees in such things as personal stock holdings and personal career development. These are specially significant in the New Zealand telecommunications industry where scale is much more limited, opportunities fewer, and market concentration much greater than (for example) the UK telecommunications industry. Incentive protections for robust separation therefore need to be very rigorous if they are to be at all effective. We do not consider that Telecom's proposed undertakings are sufficient in that regard.

In regard to ANS, the incentive arrangements purport to limit incentive payments to reference ANS own performance, without reference to Telecom Group performance. But the internal performance measures for ANS can themselves be determined (transparently) or strongly influenced (less transparently) by the role of Telecom Group CEO and Board in approval of ANS business plans, technology plans, and significant investment decisions. ANS performance measurement can thus be influenced by the strategic priorities of Telecom. Additionally, the planning

oversight of the Telecom Board and senior executives must be a background consideration for the day to day decisions of any ANS executive whose career aspirations are not limited to ANS.

In regard to the Wholesale Unit, the allowance that 80% of incentive remuneration for the Unit Manager, and 20% of incentive remuneration for second tier management of the Unit, may be derived from Group performance makes a farce of the Wholesale Unit's supposed separate business objectives..

The more positive Unit-oriented incentives of other Wholesale employees might seem to place them in motivational conflict with their senior managers. However, it would be a trivial matter for managers who were motivated by Group profitability to reduce the importance of Unit-oriented incentive payments to their employees, by raising base salaries or other rewards not formally based on performance, thus maintaining a happy ship that was motivated to deliver poor results to its supposed customers outside Telecom.

## **OPPORTUNITY**

ANS will have very limited capacity to operate other than in the interests of Telecom Group as determined by Telecom's Board. Arrangements seem designed to discourage competitive infrastructure investment, to limit the appeal of direct infrastructure access through ANS, and to shape a national market in which Telecom's Wholesale Unit retains significant market power. Telecom proposes a mechanism by which the Wholesale Unit would act as the sales agency for ANS "if that is what customers want". The outcome of this would be for Telecom Wholesale to capture a potentially significant proportion of the customer relationships that might otherwise exist between ANS and potential direct access seekers, and in our view this is quite inconsistent with robust operational separation.

It is understandable for Telecom's Board and management to seek these outcomes, consistent with their fiduciary responsibility to their shareholders. However, we consider that it would be inconsistent with the Telecommunications Act for the Minister to permit these outcomes, contrary to the stated intentions of the Act as recently amended.

The proposed undertaking, despite some improvements, still contains many loopholes and limitations that would give employees of the business units extensive opportunity to favour the interests of Telecom business units over competitors. We attach a listing (in order of appearance in Telecom's revised undertaking) that identifies our ongoing concerns. Many of these points were brought to the attention of the government and Telecom in our original submission, but have not been answered.

Consequently, TUANZ believes that the Minister should not approve Telecom's revised undertaking in its current form.

## **Limitations on effective operational separation in Telecom's revised draft undertaking.**

### **Definitions**

#### **"Resale equivalence" pricing**

The pricing of EOI services at the "average" of all Telecom services is not appropriate. Telecom's "average" will be inflated by the high costs of servicing the most difficult access customers who are the least likely to be targeted by Access Seekers. The pricing should be based on Telecom's average "in like circumstances".

The overall definition is improved, but still does not ensure that a resale operator will be provided with the same level of real-time network information to enable it to provide customer service to match that of Telecom.

**1.2(b)(i) "Trivial differences"** appears in many places throughout the undertakings but is nowhere defined, leaving scope for continual disagreement between Telecom and access seekers. Trivial differences to Telecom may be significant to the business case of an access seeking service provider. Trivial still needs to be defined as "having no material effect on the ability of a service provider to provide service at a standard equivalent to services provided by Telecom". If Telecom is unable to undertake such a definition, then the Commission must adopt and apply it.

**1.2(b)(iii) Allowance of variations to the undertakings** "agreed by Telecom and Commission in writing". This could only be considered robust if the Minister's determination requires any such agreement by the Commission to follow public consultation.

### **Interpretation**

#### **6. Undertakings limited to scheduled services.**

Since the undertakings remain limited to services that are already scheduled, the value of the proposed undertakings will rapidly decay with the progress of new technologies and migration to new services in which Telecom's vertically integrated service provision will not be subject to the undertakings. This does not amount to a robust operational separation because the businesses themselves are dynamic and investment will be withheld if the undertakings are seen as ephemeral.

**7.2 Telecom Board may override the manager of a notionally separated Business Unit** as to their obligations under the undertakings, so long as this is reported to Commission and IOG with an assertion that the action is consistent with operational separation.

The Board's assertion of consistency must not be accepted as prima facie validation of an action that could be in breach of the undertakings. Such an action can not be valid unless and until the IOG and the Commission have given their agreement to it. In giving agreement, the Commission must apply its own obligations under the Act, specifically s.18, and s 69A, where the promotion of competition is the explicit purpose and the corporate interests of Telecom (or any other individual service provider) are incidental.

7.3 Even a rigorous reporting of formal "participation" in ANS decisions does not provide any protection against the much more likely situation that **recommendations from ANS to the Telecom Board will be "massaged" before presentation to the Board**, therefore simply "approved" by the Board (which under 7.4 means the Board has not "participated" in the decision), and so the reporting requirement under 7.3 will not be triggered and neither IOG nor the Commission need be informed.

**7.4 and 7.5 give very broad powers for CEO and Board to direct ANS and Wholesale Unit**, which substantially undermines any notion of "robust separation" at the strategic level.

### **13 Business scope of ANS**

The Board's and CEO's power to change the scope of ANS business remains fettered only by the general requirement to be "consistent with robust operational separation", subject to "notification" of IOG and Commission.

Such changes should only be considered consistent with robust operational separation if they have been approved in advance by IOG and Commission.

### **14 Access Network exclusions**

14.2 This continues to exclude from the scope of the Access Network various facilities that may be essential for access seekers: terminal multiplex equipment, optical termination equipment not connected through a distribution frame, and DSLAMS. These items may be essential and not duplicable in environments such as large multi-occupant office buildings that are most likely to house potential customers of competitive access seekers.

The exclusions preserve an important advantage for the incumbent, because these facilities, which may be access facilities, can be held by Telecom retail, not Wholesale or ANS.

### **17.1(b-d) ANS investment decisions under Group control**

ANS investment decisions remain subject to approval by Telecom Board or CEO. Such decisions on technology and investment can radically affect whether the access network is maintained, and develops, in a way that is favourable to competitive access, or on the contrary is favourable to Telecom's vertical supply chain.

### **20 Fibre to the Premises Access Service conditions and reciprocity**

Taken together with 65, this provision still ensures that to all intents and purposes Telecom will operate a FTTP infrastructure and wholesale monopoly. ANS will not make FTTP infrastructure available to access seekers, and Telecom's assertion of a right to reciprocal access to any FTTP access infrastructure installed by a competitive investor, can be guaranteed to prevent any such competitive infrastructure emerging.

It is counter to the entire purpose of the undertakings, which is to provide some measure of balance against Telecom's significant market power in all relevant markets. No investor with a small market share could contemplate investing in an infrastructure that would immediately be overwhelmed by Telecom's claim for access at a level that would reflect Telecom's pre-existing market share. There is no justification to allow "reciprocity" to be a valid consideration in this matter, since the Government's legislated measures regarding access regulation are all being taken specifically to countervail Telecom's ability to use its market power to crush or discourage competitive market entry.

### **23 Limits on ANS provision of services ready for EOI standard**

23.2 This allows ANS to build services exclusively for Telecom, or exclusively for another service provider, subject to the agreement of the Commission. We are uncomfortable that this overt purpose is framed to allow an unlimited range of "minor" exceptions, of which exclusive service provider demand is only provided as an example. We foresee that the Commission would be asked to consider many other purportedly "minor" exceptions to EOI that would cause extended doubt and uncertainty in the service provider market and discourage competitive investment.

If the undertakings were to be truly robust, then all "minor exceptions" clauses would be deleted and exceptions would be dealt with through the open, public process of applying to the Commission for an amendment of the undertaking.

### **24 ANS can be "represented" by Telecom Wholesale**

24.3.1 allows for Telecom Group to use its vertical and horizontal marketing advantages to corral the maximum market share away from ANS and into Wholesale, which would then act as "sales agent" for ANS. The trigger for this situation is a one-off "plebiscite" of wholesale customers in which Telecom alone decides whether a "significant" number of customers want to avoid dealing with ANS. We consider it highly inconsistent that Telecom Wholesale should be empowered to interpose itself between potential customers and ANS. It should be limited to selling its own wholesale products, which are in any case based on ANS services.

### **27 Telecom CEO and Board set ANS annual and long-term corporate and technology plans.**

The involvement of the Telecom CEO in development of these plans prior to their submission to the Board, and prior to their review by the IOG, invalidates any notion of a robust separation. The CEO and the Board have an inviolable fiduciary

duty to act in the interest of Telecom Group, and ANS management have no authority, under these undertakings, to act other than in accordance with plans approved by, and in the interests of, Telecom Group. 27.2 (b) the attestation by the Board that their involvement, and that of the CEO, is consistent with the undertakings is meaningless, because the undertakings do not require CEO or Board to apply any defined separation to the investment and operational priorities of ANS, but 28.1(a) requires that ANS management act only in accordance with plans approved by Telecom Group.

**30 "Acting in ANS' best interests" is defined away,** because ANS's interest are defined by Telecom Group CEO and Board.

**34 ANS Unit's commercial information will be available to the Telecom CEO and Board** in the context of approval of plans and major investments, so the restriction on information flow at employee level is only partially effective.

### **Claim for reciprocity on FTTP and IP interconnection**

#### **65.4 Reciprocity on FTTP access**

#### **66.7 Reciprocity on IP interconnection**

Reciprocity is an illegitimate requirement in these undertakings, because the undertakings themselves are "voluntary" only in name, since they are being proposed solely to forestall regulated operational separation that is otherwise mandated by the Telecommunications Act to address identified problems arising from Telecom's substantial market power in all relevant market segments.

**88 General rules offer many ways in which commercial information may be shared inappropriately,** and commercial behaviour may favour Telecom business units as against other Service Providers.

#### **88,89,90 Rules for Part A, Part B, Part C persons not firm**

The repetition of terms such as "legitimate need" and "no more than necessary" governing the restraints on Telecom employees in possession of commercially-sensitive information, give no certainty of confidentiality to non-Telecom service providers. Only a strict requirement of absolute confidentiality except with express permission of the relevant service providers could be considered meaningful.

#### **100. Access Planners exempt from arms-length provisions.**

Telecom's explanation of the role of Access Planners within ANS does not provide any valid reason for Access Planners working for ANS to be exempt from the arms length provisions, or to be defined as "applying the Telecom fixed network group policies and investment tactics prepared by Group Technology." If they are working for ANS and ANS genuinely controls the access network assets, then their planning responsibilities ought to apply to the whole ANS market, in which Telecom Business Units may be their largest, but not only, customer. There is nothing to prevent Telecom's other Business Units having appropriately qualified

employees to ensure that their access planning needs are properly communicated to ANS in line with service development and marketing requirements of the unit. It is quite inappropriate that ANS Access Planners should be subject to direction of/ by Telecom fixed network business units.

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