

Problems for NZ's UBS Pricing Apparent from New UK Judgment

January 2007

A major UK appeal judgment shows that the new UBS, Naked DSL and LLU pricing regime has serious difficulties.

Introduction

Government has achieved what was unthinkable a year ago with the December Telecommunications Amendment Act 2006. However, 2 new Competition Appeal Tribunal judgments show there are serious problems with the way in which UBS and Naked DSL are priced in the Act (on a retail-minus basis).

In particular, the judgments demonstrate problems with the retail-minus pricing method itself. Flowing from this are difficulties in the relationship of the UBS/naked DSL pricing with the cost-based pricing approach for LLU.

The two judgments of the UK Competition Appeal Authority were delivered in October and December: *Albion v. Water Services Regulation Authority*. In this article we won't go into the detail as it's set out in two other articles on our website:

Retail-Minus Pricing (aka ECPR) panned by UK's Competition Appeal Tribunal

Margin (Price) Squeeze: A Landmark December 2006 UK Judgment.

Disclosure

Among our clients, we act for parties that seek to reduce the imposition and impact of ECPR. However this article has not been prepared on instructions from clients.

Implications for New Zealand

While *Albion* was decided on its own facts (and it's important to emphasise that each situation needs to be reviewed on its own facts) the Tribunal's strong reservations about

retail-minus pricing (as implemented in New Zealand) are apparent.

Among other things, *Albion* shows:

- A simple retail-minus model (such as we have in New Zealand) is frequently flawed. For example, it often does not prevent price squeezes by the incumbent, and indeed can cause price squeezes. Further, generally only "super efficient" competitors can succeed against the incumbent (just being "efficient" is not enough). That is because the competitor must support both the incumbent's overheads as well as its own.
- The net effect of retail-minus pricing is that it will often be anti-competitive, in contrast with the aim of the Telecommunications legislation to achieve competition in the long-term interests of end-users.¹
- For retail-minus to have any chance of working, the retail price must also be regulated. That view was held by the originators of the rule (Professors Baumol and Willig, and Dr Kahn) and was accepted by all experts in the *Albion* case too. That is not happening in New Zealand and this leads to the adverse consequences noted in our online article on retail-minus pricing, including risk of preservation of monopoly profits, inefficiencies and cost misallocations.
- Even then, there are real reservations as to whether retail-minus in its basic form is an appropriate methodology.

¹ Section 18 Telecommunications Act 2006

It is ironic that New Zealand is one of the few countries that has a basic retail-minus model yet it does not regulate the retail price. That is particularly so, as New Zealand was the “early adopter” of the retail-minus model and the Privy Council decision notes, in effect, the need to regulate the retail price where the incumbent is in a dominant position.

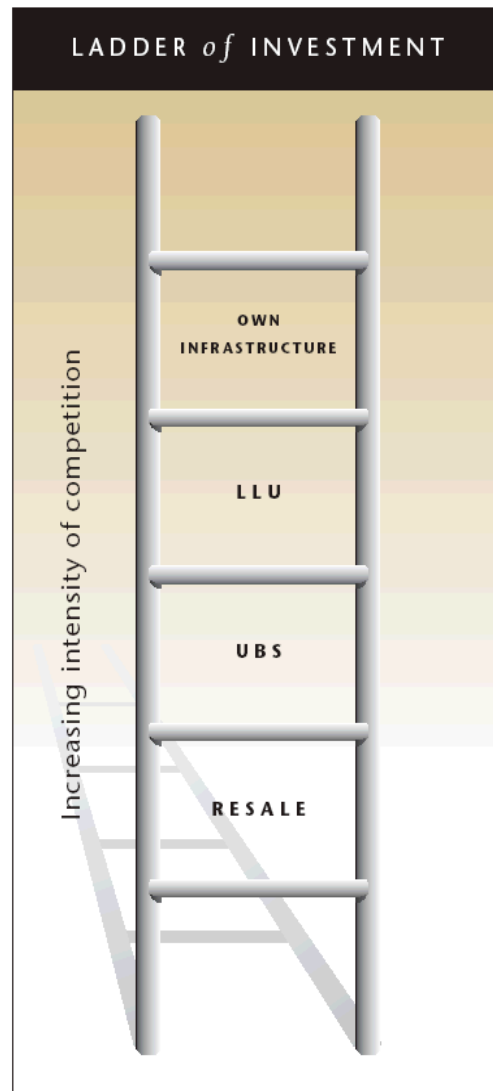
In the limited situations where retail-minus is still being used, there tends to be detailed structures added to safeguard against the risks such as gaming, price squeeze etc. An example is the January 2006 approach of the Irish regulator to retail-minus pricing of DSL access², which involves a detailed model, the primary aim of which is to avoid price squeeze (when the model used in NZ can, to the contrary, cause price squeeze).

It’s apparent from the *Albion* judgment that, in continuing use of the basic retail-minus model that gives little flexibility to the regulator, New Zealand is swimming against the international tide.

In its submissions on the Telecommunications Bill, the Commerce Commission in Appendix 1³ has provided an excellent summary of the international experience, problems and issues with retail-minus, and solutions adopted in various jurisdictions.

Ladder of Investment

One of the biggest problems is that it will be difficult to make the “ladder of investment” work. The ladder of investment (see diagram) is the conceptual framework on which much of December’s amendment to the Act is built. The idea is to encourage facilities-based competition by structuring prices and access to services so that providers are encouraged further up the ladder to invest in infrastructure.



Critical to this is a pricing regime for UBS, Naked DSL, and LLU which encourages the right investment decisions for the incumbent and its competitors. Get the relativities between the pricing wrong and the market faces the wrong incentives, so the ladder doesn’t work.

When fixing the price of UBS and naked DSL, the Commission is required by the Act to have regard to the relativity between those products and LLU.⁴

There is an initial problem on this: compared with other retail-minus implementations in other countries, the retail-minus statutory

² http://www.comreg.ie/_fileupload/publications/ComReg0601.pdf

³ http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/GeneralInformation/ContentFiles/Documents/492059_4.pdf

⁴ See the description of UBS in Schedule 1 in the Act

definition is prescriptive and allows limited room for movement beyond implementation of its requirements. Additionally, the existing “minus” component is regulated at 16% and there is no sign that this will be revisited by the Commission anytime soon (no access seeker in practice is likely to apply, in view of cost etc). Yet the 16% may not correctly reflect the avoidable costs for these types of services.

Therefore the Commission has little room to have regard to the price relativity between UBS, naked DSL and LLU.

But the *Albion* judgment shows there are more fundamental problems which may well distort the market adversely.

No matter how far the Commission might try to achieve the optimal outcome, under retail-minus, a key component is outside its control. It is limited to fixing the price for UBS and Naked DSL with reference to the retail price. That retail price is unilaterally chosen by the incumbent. As the Commission notes in the submissions⁵ referred to above:

“49. The very nature of the retail minus pricing principle means that the Commission cannot influence the relative prices and margins between access products, since by definition the bitstream price will depend on Telecom’s retail pricing behavior whereas the LLU price would be cost-based. That the pricing principles contained in the Bill direct the Commission to consider relativity between LLU and UBS when setting the price of each of these services does not adequately deal with the issue, as the descriptions for the two services are prescriptive as to which pricing approach is to be followed.”

Add to this the fact that a retail-minus pricing model will produce pricing quite different from costs-based pricing, as is apparent from the *Albion* judgment. There are apple and pear differences, unrelated to getting the pricing right to help the ladder of investment to work.

How this plays out is anyone’s guess, as the Commission moves to regulate the prices. How

⁵ Para 49 Appendix 1 submissions of Commerce Commission to Select Committee in respect of Telecommunications Amendment Bill 2006.

does a competitor makes its investment decisions? The incumbent has total control of the key variable in respect of UBS and Naked DSL (namely, the retail price). It can unilaterally make decisions which either encourage or discourage UBS/Naked DSL on the one hand or LLU on the other (just as possible is discouragement in respect of all 3 services).

Of course there is some constraint on what the incumbent can do under the Commerce Act. But this is of only limited effect: the Act is a blunt instrument and, except in most unusual situations where urgent relief can be obtained, produces results (at great cost) several years after the main events occur.

There will of course be market place drivers for fixing retail prices but, again, *Albion* illustrates why this isn’t necessarily an answer to the problem.

As the Commission further notes⁶:

“50. The pricing method included in the Telecommunications Amendment Bill for LLU and bitstream is not in line with evolving international best practice and is likely to be cumbersome to implement. Further, it does not provide the Commission with sufficient ability to manage the margin between the LLU and bitstream prices as well as the necessary flexibility to adjust those margins in response to changing competitive conditions. Failure to provide an appropriate margin between the LLU and bitstream services is likely to have adverse consequences for the up-take of LLU, the investment incentives of Telecom and its competitors, and ultimately for the promotion of competition.”

Solutions

Appellate decisions on retail-minus are rare. So, *Albion* is a major development at the end of last year. There has been considerable time and practical experience since *Telecom v. Clear* was decided in 1994. At the very least, the current model should be reviewed to see if there are reasons why it should not be

⁶ Para 50 Commerce Commission submissions.

changed or dropped in light of the various issues raised in *Albion* and elsewhere. Government might revisit and legislate to amend the pricing methodology, in view of *Albion*, to a cost-based approach, given the indications there will be market failure with the current model. Leaving this to see how things play out is problematic in view of the time lag involved. It will be well into 2008 before difficulties if any become apparent. Change at that point wouldn't bite for another year or two in view of law change requirements followed by price setting by the Commission. Left as is, the issue is unlikely to be solved for 3 to 4 years.

Even better would be to have the sort of flexible model (which enables a flexible response as matters develop), along the lines suggested in the Commission's submissions.

If change away from retail-minus is too difficult, it follows from the new judgment that regulated retail services should be added to the Act. In this way, what is recognised as an essential requirement (regulation of the relevant retail price) is added to what is only a partial solution (the retail-minus formula).

Additionally, the Commission could be given flexibility to develop the retail-minus model to overcome risks such as gaming, price squeeze, and the difficulty that, often, only a "super-efficient" competitor can succeed. Restricting a solution to a retail-minus model will still be problematic as the judgment identifies (and as is set out in some detail in the Commission's submission). But at least it would be a step forward.

The Commission can of course instigate a schedule 3 investigation but we imagine that is an unlikely scenario in the short term. Instead the Commission could instigate an investigation utilising its new more informal proactive investigative powers.⁷ However, the Commission has a lot on its plate at present.

Finally, the Cabinet paper notes that Government intends to review whether pricing is working; perhaps that review could be expedited in light of these new judgments.

Conclusion

Telco regulation is a difficult area and Government has achieved the unthinkable in the space of around a year. However, this new information shows there are problems with pricing of UBS, Naked DSL and LLU.

We welcome your feedback on this article and any enquiries in relation to its contents. This article is intended to provide a summary of the material covered and does not constitute legal advice. We can provide specialist legal advice on the full range of matters contained in this article.

Wigley & Company is a long established specialist law firm. Our focus includes IT, telecommunications, regulatory and competition law, procurement and media/marketing. With broad experience acting for vendors and purchasers, government agencies and corporates, Wigley & Company understands the issues on "both sides of the fence", and helps clients achieve win-win outcomes.

With a strong combination of commercial, legal, technical and strategic skills, Wigley & Company provides genuinely innovative and pragmatic solutions.

Wigley & Company, Barristers & Solicitors | E: info@wigleylaw.com | P: (04) 472 3023

⁷ Section 9A Telecommunications Act 2001.