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Annex 5: The benefits of structural separation: a New Zealand study

8 October 2015

Response to Ofcom's Consultation:
Strategic Review of Digital Communications Discussion document

1. Introduction

New Zealand has been realising the benefits of structural separation of the incumbent fixed line operator since late 2011. It has enabled an intensification of competition in retail broadband, delivered greater investment and innovation, and reduced the need for complex regulation.

Structural separation in New Zealand was voluntary. Telecom New Zealand (**Telecom**) demerged in order participate in a Government-funded programme of investment in a new, open-access FTTH network that will ultimately connect 75% of the population (the **UFB Initiative**).

The demerger of Telecom created two new businesses:

- **Chorus**, which became New Zealand's largest fixed communications utility business; and
- **Spark** (as it is now known), which remained New Zealand's largest provider of communications and IT services, freed from the shackles of complex regulation (including operational separation obligations).

The benefits of structural separation, for Telecom shareholders as well of the rest of New Zealand, were far greater than just Telecom's participation in the UFB Initiative. As the New Zealand Commerce Commission observed in consultation on structural separation, it promised the potential of "substantial benefits" through:

> *[b]reaking the link between retail services and the access network [encouraging] competition at the retail level and [reducing] the need for detailed regulation of the interface between the two.*

This is precisely the outcome structural separation has so far achieved in New Zealand. This short paper provides a more detailed description of this experience, as follows:

- Section 2: The impact of structural separation on the New Zealand market;
- Section 3: How structural separation delivered these benefits; and
- Section 4: The challenges that have arisen.

2. Impact of structural separation on the New Zealand market

Looking forward to the future of regulation of the telecommunications sector, New Zealand's Ministry of Business, Innovation and Employment recently found that "investment is occurring at high levels" and "retail competition is strong".[1]

Specifically, the Ministry observed the impact of structural separation as follows:[2]

> *The creation of Chorus as a stand-alone wholesale network operator of both copper and UFB networks means that New Zealand now has a level playing field amongst retail fixed line*

[1] Ministry of Business, Innovation and Employment *Regulating communications for the future: Review of the Telecommunications 2001* (September 2015) at p 53.
[2] Ibid., at p 54.

operators. Strong open access and non-discrimination obligations also apply to other UFB and [Rural Broadband Initiative] providers.

Retailers now face strong incentives to differentiate their offerings through affordable, innovative and quality service offerings – including bundling with voice, mobile, fixed and content packages.

2.1 Increased investment

For the third year running, more than $1.5 billion of capital investment has been made in New Zealand's communications sector.

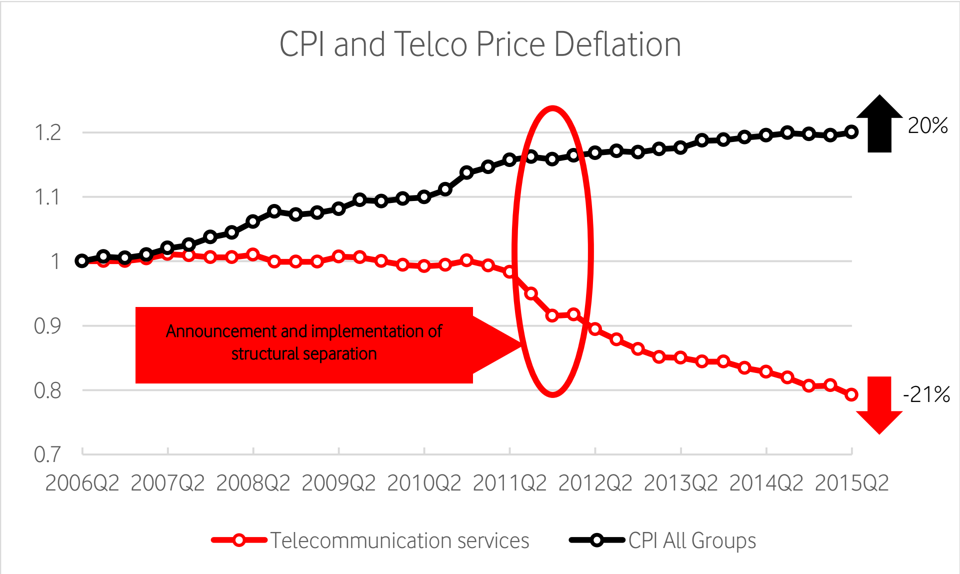
While this has been underpinned by fibre investment through the UFB Initiative, investment in non-fibre assets has also grown. For example, in the 12 month period to 30 June 2015, more than half of industry capital expenditure was from non-Chorus parties: Spark invested $576 million and Vodafone New Zealand invested more than $250 million.

This investment growth, both by Spark and by non-incumbent operators, has been facilitated by structural separation because regulatory risk is lower, certainty of access to bottleneck fixed infrastructure is greater, and competition has flourished.

2.2 Intensified competition

The investment in New Zealand's communications market, underpinned by the separated market structure for fixed infrastructure, has delivered great results for consumers. It has unleashed intense competition, driving innovation and value.

At its simplest, the impact of structural separation in unlocking the potential of a competitive retail market is demonstrated in a comparison of New Zealand's Consumer Price Index again the deflation of the price of communications services as a sub-set of that measure. Despite steady inflation generally, New Zealanders receive considerably greater value for communications service.



When measured since 2006Q2 (the index date for CPI in New Zealand), general inflation has been 20% over the period. This stands in sharp contrast to a recorded -21% reduction in the cost of communications services. Importantly, the step-change since structural separation is clear: almost half the reduction in cost took place in the period in which structural separation was "on the table", and almost all of the balance has been steadily delivered since.

Of course the benefits New Zealanders have received through intensified competition and investment are not just lower prices. Broadband speeds are faster, data caps are higher, and a range of innovative new products, services and partnerships have emerged. Since structural separation, New Zealanders have simply received more for their money when it comes to communications services.

3. How structural separation delivered these benefits

The drivers of increased investment and innovation in the New Zealand communications market were supported by three consequences of structural separation:

- Significant regulatory burdens were removed, delivering a simplified and more effective regime;
- Two new businesses were forged, which have performed better for their shareholders and for New Zealand; and
- A step-change in the competitive retail broadband market has been unlocked.

The details of each are set out below.

3.1 Separation removed significant regulatory burdens, and deliver a simplified and more effective regulatory regime

In order to enable a workably competitive telecommunications market in New Zealand, it was necessary to subject the old Telecom to significant regulation.

At the centre of this was a detailed and complex operational separation regime. On top of the financial costs of this regulation, Telecom management estimated at the time that up to 10%-15% of management time was spent on compliance with operational separation frameworks and regulations.[3] Telecom itself identified the removal of operational separation framework as an opportunity to:[4]

> *[…] significantly simplify the business operations of both [Spark] and [Chorus] and is expected to substantially reduce the cost and complexity of compliance when compared to the current regulatory environment.*

An even stronger conclusion is drawn in the independent expert report prepared for Telecom shareholders ahead of the vote on the demerger proposal. While the analysis was grounded in the fact-scenario of the UFB Initiative (and the choice for Telecom to "cooperate" or "compete"), the independent report recommending the demerger nevertheless found that:[5]

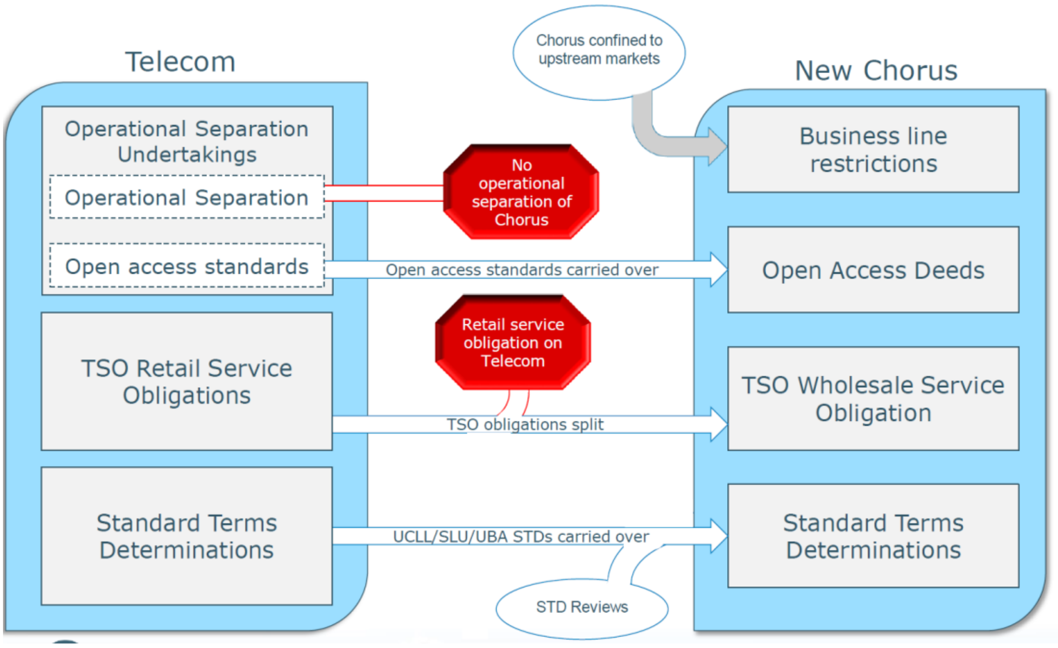
[3] Grant Samuel *Independent Expert's Report on the Proposed Structural Separation of Telecom Corporation of New Zealand Limited* (13 September 2011) at section 7.5.2.

[4] Telecom *Demerger Booklet: Share in two journeys* (13 September 2011) at section 3.6.2.

[5] Grant Samuel *Independent Expert's Report on the Proposed Structural Separation of Telecom Corporation of New Zealand Limited* (13 September 2011) at section 7.5.2.

[t]he advantages of structural separation on the release from certain regulations are compelling. In the event shareholders do not approve the Proposed Separation [Telecom] could still progress to structural separation if it could be assured of the associated regulatory relief.

Chorus has recently summarised the transfer in regulation as follows:[6]



Ultimately, this shift translates to less regulation for Chorus and, to the extent regulation remains, by definition it affects a smaller party. For Spark, excepting its residual TSO obligations in the fixed space, it has now been unleashed as a highly competitive operator on comparable footing to the rest of the market. Meanwhile, for all parties, a significant portion of the expertise, time and expense which was previously required for regulatory compliance has been freed up for investment and innovation.

3.2 Structural separation forged two new businesses, which have performed better for shareholders and New Zealand

Structural separation fundamentally changed the dynamic of both Chorus and Spark. At an economic level, it delivered greater management and board focus on each business, while improving financial flexibility for both entities. More importantly though, it has changed behaviour.

3.2.1 Fundamental shift in behaviour – Spark and Chorus

Structural separation shifts incentives. Ultimately, that means it shifts behaviour. The change in New Zealand has been stark.

[6] Chorus New Zealand *Telecom New Zealand Limited to Chorus Limited: Presentation to UK Broadband Stakeholder Group* (September 2015) at p 15.

In the case of Chorus, it has truly re-positioned as a pro-active wholesaler. In its first full annual report following the demerger, Chorus described structural separation as:[7]

> *[a] significant change, where the underlying fixed line communications infrastructure is available to everyone on a level playing field, [which] requires a new way of thinking for the telecommunications industry. It changes the investment choices and competitive dynamics for companies like Telecom, TelstraClear, Vodafone, Orcon, CallPlus and many other retail service providers.*

The report continued, observing the specific opportunities now available through separation and Chorus' role in realising them:[8]

> *Ensuring a smooth transition through demerger for retail service providers was pivotal to success for Chorus.*
>
> *It worked hard to achieve this and with the transition phase largely complete, Chorus is now focused on building retail service provider customer relationships and taking advantage of the significant opportunities separation presents for Chorus and retail service providers.*
>
> *New retail service providers are keen to do business with Chorus, with its new business development sales pipeline increasing month by month. By the end of June 2012, Chorus was working actively with around 30 potential new retail service providers.*
>
> *Chorus' customer base is mainly made up of retail service providers that buy both layer 1 and layer 2 services. Chorus has been working with retail service providers around what the shift to fibre means for them and their end user customers, and helping them with their business case for fibre by utilising analysis of local market and global trends.*

This culture is simply not imaginable from a vertically-integrated monopolist like old Telecom. While there are still important regulatory and commercial needs to keep Chorus to account (it is, ultimately, the owner provider of copper access services and the only choice for fibre services across most of New Zealand), structural separation incentivises a much clearer commercial partnership between Chorus and its customers.[9] In contrast to the ultimate economic reality of old Telecom, for Chorus to win in the market it needs its customer to be winning too.

Ultimately, Chorus' incentives are to support all of its wholesale partners to drive uptake of broadband services and improve the broadband customer experience in New Zealand. This means retailers genuinely operate as partners with Chorus, and we see our relationship with Chorus as key part of delivering the ambitious goals for customer experience and network quality we hold for our customers.

From an industry perspective, the change in Chorus' approach is evidence in a range of new behaviours. For example, Chorus has placed a renewed emphasis on exploring new commercial products. It has observed:[10]

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[7] Chorus New Zealand *2013 Annual Report* (29 August 2013) at p 5.
[8] Ibid.
[9] See discussion on the need for monopoly regulation, at section 4.3.
[10] Chorus New Zealand *2013 Annual Report* (29 August 2013) at p 6.

> *While copper products are core to Chorus' portfolio today, Chorus' success and future growth requires an innovative approach to product and service development that responds to the transition from copper to a new fibre world. Chorus is working closely with retail service providers and the wider industry on development of these new services.*

This attitude was largely reflected in its announcement of the Chorus Accelerate programme, which proposed a new set of broadband products intended to deliver greater speeds, enhanced HD video capability, more choices for RSPs, and a clear path toward fibre uptake. Chorus Accelerate proposed:[11]

- New fibre products over and above the minimum standards specified in Chorus' agreement with Crown, with higher speeds and service designed to support RSPs in genuinely offering 100Mbps fibre (i.e., Chorus would provision those services at slightly above 100Mbps to allow "right performing" plans at a retail level);

- Boost HD, which was a proposed copper service including a service commitment that there will be enough bandwidth available in the Chorus network that RSPs will be able to deliver a service allowing for an HD video stream at all times; and

- Boost VDSL, which was a VDSL-based product which includes a "fibre ready" installation that would get the wiring within a property ready for fibre for an easier upgrade when it becomes available in that area.

Although the copper aspect of the Chorus Accelerate programme were ultimately withdrawn by Chorus, we consider that the initiative to introduce these types of services is a highly positive one.[12]

At the time, Vodafone strongly supported the opportunity for the wholesale market to include innovative commercial products that are distinct from underlying regulated services and enable higher quality telecommunications services for New Zealanders.[13] We also engaged pro-actively through the industry engagement, and welcomed the robust information Chorus provided all industry participants in proposing the new product set.[14]

More recently, Chorus has launched the first phase of its business service wrap. This proposition responds specifically to industry feedback, and proposes five improvements across premium business and education services:[15]

- Increased price certainty through the introduction of rate card pricing for applicable builds and installs (replacing an existing "POA" regime);
- Faster fault resolution targets;
- Pro-active verification of network connectivity on connection and new test tools;
- Establishing dedicates team for provisioning and support; and

[11] Chorus New Zealand *Chorus Accelerate delivers step change to New Zealand's broadband capability* (media release, 14 May 2014).
[12] The proposed commercial copper services were ultimately withdrawn. For more information, see the discussion below in section 4.
[13] Vodafone *Submission on Issues Paper assessing Chorus' new UBA variants – Boost HD and Boost VDSL* (18 July 2014).
[14] See, for example, Chorus New Zealand *Boost Update: Dialogue July 2014* (10 July 2014).
[15] Chorus New Zealand *Business service wrap* (August 2015).

- The ability to coordinate multisite customer orders.

The change in Chorus' behaviour is evident in more than just its product set. Vodafone is also pleased to be working closely with Chorus, alongside other RSPs, on improving the end-user experience for fibre installation.[16] Chorus has demonstrated its capacity to take a leadership position on this issue, in advocacy for improving regulatory settings, aligning industry processes, and improving its own approach. Similarly, Chorus has embarked on a $50 million programme to upgrade its OSS/BSS systems to work better with all RSPs in provisioning their services.[17]

The change has been just as profound at Spark. Prior to the demerger, Grant Samuel identified that the company had limited scope to expand through acquisition, joint venture or commercial arrangements (largely as a result of competition and regulatory constrains).[18] These shackles have been unequivocally removed, with a step-change in Spark's competitive positioning in the retail market (in both fixed and mobile). Spark has, for example:

- launched its own subscription video on demand service, Lightbox, which it has made available free for the first 12 months to its full customer base;

- launched new, low-cost brands in fixed (Bigpipe) and pre-paid (Skinny). These services are priced at a discount to Spark's primary brands, and have had a meaningful gain in both growing Spark market share and on driving more value for New Zealand consumers across both fixed and mobile markets;

- invested in a range of innovative new services, like home security service Morepork;

- led the bidding for 700MHz spectrum; and

- investing $70 million per annum over 3 years in a major re-engineering programme, which included development of a single CRM system.[19]

Spark itself identified this opportunity in its first half year report following the demerger with Chorus, describing itself as *"positioned for success post-demerger"* with a *"significantly reduced regulatory burden"* and the new-found ability to *"compete on a similar footing with market peers"*.[20]

The changes to incentives and behaviour are compounded by the practical impacts of structural separations: they position management with better focus and provide better financial flexibility.

3.2.1.1 Greater management and board focus

By creating two new entities, structural separation created two companies with separate boards and senior management teams focused on the specific objective of their businesses. As the Grant Samuel report observed, the board and management of each entity:

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[16] Chorus New Zealand *Chorus Full Year Result FY15 Investor Presentation* (24 August 2015) at pp 34 – 36.
[17] Chorus *New Zealand UFB update* (26 May 2015).
[18] Grant Samuel *Independent Expert's Report on the Proposed Structural Separation of Telecom Corporation of New Zealand Limited* (13 September 2011) at section 7.5.4.
[19] Spark New Zealand *Spark NZ completes milestone in reengineering programme* (media release, 9 March 2015).
[20] Spark New Zealand *H2 FY12 Result Briefing* (24 February 2012) at p 5.

> *[…] will be able to focus on their respective strategic objectives, make decisions appropriate to each business' risk/return profile and address specific operational issues in a timely manner. Each entity will be required to fund future growth from its own resources, providing additional discipline on capital and operating expenditure. The Proposed Separation will make it easier to more closely link the remuneration of management to the performance of businesses over which management has direct control.*

3.2.1.2 Greater financial flexibility

Since structural separation, Chorus and Spark have been better positioned to exploit growth opportunities and better manage their capital structure according to the specific needs of their businesses. Chorus has appropriately positioned as a communications infrastructure business, with Spark assuming the position of a competitive retail-focused business.

This translates to distinct decisions around debt and equity, enabling more efficient investment by both companies. At its simplest, when compared to Telecom, gearing is higher for Chorus and lower for Spark: this appropriately reflects the fundamentally different risk profiles of each business.

3.2.2 Supporting a step change in a competitive retail broadband market in New Zealand

As set out above, in section 2.2, New Zealand's retail broadband market is more competitive and diverse than ever before. As expected, structural separation has supported new entrants and has driven an intensification in competition.

As Crown Fibre Holdings observed in its 2015 Annual Report:[21]

> *Competition amongst RSPs is fierce, with 87 RSPs currently selling UFB and new entrants gaining market share. These range from large telecommunication firms offering nationwide services to small operators with services available in single towns. Niche providers are creating attractive business products and services in areas such as cloud computing, hosting and security.*
>
> *In the residential market, retailers are offering innovative utility bundles with power and gas, as well as video, mobile phone and gaming options, providing consumers with real choice.*

In its study of price trends in retail fixed line broadband services from 2011 – 2014 (effectively the period since structural separation), the New Zealand Commerce Commission observed that "[r]etail prices for broadband and voice service bundles have dropped markedly in recent years".[22]

Furthermore, the emergence of new operators like Snap, has had spill-over effects on the wider New Zealand communications market: earlier this year, the company was acquired by New Zealand's third established mobile operator 2degrees. In announcing the acquisition, 2degrees described Snap as providing the *"the perfect complement to our mobile offering and will allow us to deliver the total package that our customers – and theirs – have been asking for"*.[23]

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[21] Crown Fibre Holdings *Annual Report 2015* (3 September 2015) at p 7.
[22] New Zealand Commerce Commission *Price trends in retail fixed-line broadband services, 2011 to 2014, and the impact of wholesale price changes* (June 2015) at p 5.
[23] Two Degrees Mobile *2degrees and Snap - there's a real choice of total telco service coming your way soon* (media release, 23 March 2015).

4. Challenges from New Zealand

4.1 Unpacking the Government's role in UFB and Rural Broadband investment

The Government's investment through in the Ultrafast and Rural Broadband Initiatives has, of course, hade a major impact on the shape of New Zealand's communications market and the journey toward structural separation.

Despite this, the benefits of structural separation described above remain plain to see. New Zealand is benefitting from an industry that is both more competitive (between a diverse range of retailers) and collaborative (with Chorus better incentivised to work with all retailers).

In addition, we note that structural separation has enhanced the ability of the New Zealand taxpayer to achieve value for money through the UFB Initiative. When the Government announced further funding to extend UFB to 80% of New Zealanders or more, our response was simple:[24]

> *As a major Fibre retail provider, we support New Zealand's Fibre future, and the expansion of the Ultra-Fast Broadband programme. We believe Chorus and existing LFC providers can expand UFB from 75% to 80% of New Zealanders in the most cost effective and efficient way.*

While the Government's role in broadband investment presents its own challenges and opportunities for the New Zealand market, structural separation remains at the heart of a fixed broadband market structure that is better tuned to promote the long-term benefits of end-users in New Zealand.

4.2 Impact of copper pricing process

As set out above, Chorus has described the regulatory process for setting copper prices as "dominating" its share price performance since structural separation.

Vodafone has always taken the view that the transition that occurred in New Zealand, from predominantly retail-minus to cost-oriented pricing for Chorus copper services, should result in lower wholesale copper prices than those that existed prior to structural separation. We think that's the outcome required under the Telecommunications Act, and the outcome that will best promote the long-term benefits of end-users in New Zealand.

Importantly though, this challenge does not exist in the UK. With Openreach already subject to cost-oriented pricing for its copper products, to the extent this has been a transitional challenge in New Zealand, it is not an issue in the UK.

Finally, we note that structural separation has ultimately delivered positive outcomes for investors in the New Zealand communications market. While Chorus describes the process of deciding the price for regulated access to its copper network as "dominating" its share price performance, structural separation points in the long-term to positive returns for original Telecom shareholders.[25]

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[24] Vodafone New Zealand *Government commitment to further broadband development positive* (media release, 12 March 2015).
[25] Chorus New Zealand *Chorus Full Year Result FY15: Investor Presentation* (24 August 2015) at p 44.

4.3 Monopoly regulation is still required for Chorus

Structural separation has removed the challenges of discrimination inherent in a vertically-integrated monopoly provider of fixed-line services. That means a simpler regulatory model, reflecting the change in Chorus' incentives in particular, can apply.

It does not however mean that no regulation is required. The current regulatory regime is a combination of regulated copper access services, fibre prices set through a competitive tender process with the Crown (supporting by an open access deed of undertaking), as well as line of business restrictions on Chorus (effectively it may only operate as a wholesaler) and residual universal service obligations.

The Ministry of Business, Innovation, and Employment is currently consulting on the future of telecommunications regulation in New Zealand. The Ministry observes:[26]

> *The scope for anti-competitive behaviour in the telecommunications sector has diminished with the structural separation of Telecom and the arrival of wholesale-only Local Fibre Companies (LFCs). Despite recent market consolidation, retailers now face strong incentives to differentiate their services through affordable, innovative and quality service offerings – including bundling their products with voice, mobile, fixed, and content packages.*
>
> *This has been achieved against a backdrop of regulation, and it is not clear that competition is sustainable without this support. While fixed network owners now have fewer incentives to discriminate, they may still be able to charge monopoly prices to the disadvantage of consumers. There are unlikely to be strong incentives to keep increasing the quality of their wholesale service offerings, without some regulatory stimulus (such as requiring unbundling), and rules will need to be retained to prevent them entering retail markets.*

Although the consultation is in its early phases, it is clear that structural separation of the incumbent fixed line monopoly provides a robust platform for designing a regulatory framework that will clearly support the long-term interests of end-users.

[26] Ministry of Business, Innovation and Employment *Regulating communications for the future: Review of the Telecommunications 2001* (September 2015) at p 14.