IN THE SUPREME COURT OF NEW ZEALAND

SC 4/2010
SC 44/2010
SC 45/2010
SC 46/2020
[2011] NZSC Trans 4

BETWEEN **VODAFONE NEW ZEALAND LIMITED**
Appellant

AND **TELECOM NEW ZEALAND LIMITED**
First Respondent

COMMERCE COMMISSION
Second Respondent

BETWEEN **COMMERCE COMMISSION**
Appellant

AND **VODAFONE NEW ZEALAND LIMITED**
First Respondent

TELECOM NEW ZEALAND LIMITED
Second Respondent

BETWEEN **TELECOM NEW ZEALAND LIMITED**
Appellant

AND **VODAFONE NEW ZEALAND LIMITED**
First Respondent

COMMERCE COMMISSION
Second Respondent

BETWEEN **TELECOM NEW ZEALAND LIMITED**
Appellant

AND **VODAFONE NEW ZEALAND LIMITED**
First Respondent

COMMERCE COMMISSION
Second Respondent

Hearing: 21-24 February 2011

Court: Elias CJ
Blanchard J
Tipping J
McGrath J
Gault J

Appearances: B D Gray QC, A E Ferguson and F C Monteiro for Vodafone New Zealand Limited
J E Hodder SC, B A Davies and L C James for Telecom New Zealand Limited
M T Scholtens QC and J B Hamlin for the Commerce Commission

CIVIL APPEAL

MR GRAY QC:

May it please Your Honours I appear for Vodafone New Zealand Limited and with me Ms Ferguson and Ms Monteiro.

ELIAS CJ:

Thank you Mr Gray, Ms Ferguson, Ms Monteiro.

MR HODDER:

If the Court pleases, I appear with my learned friend Ms Davies and Ms James for the Telecom entities.

ELIAS CJ:

Thank you Mr Hodder, Ms Davies, Ms James.

MS SCHOLTENS QC:

May it please the Court, I appear with my learned friend Mr Hamlin for the Commerce Commission.

ELIAS CJ:

Thank you Ms Scholtens and Mr Hamlin. Have you discussed how you're going to approach this?

MR GRAY QC:

Yes we have, we have. There's a high degree of overlap within the three appeals.

ELIAS CJ:

Yes.

MR GRAY QC:

We thought that Vodafone's appeal, being first filed and relating to the prior period, would go first; therefore I would lead as appellant, Mr Hodder would respond and at the same time argue in support of Telecom's two appeals, with the Commission to do likewise, and they merely wrap up, replies to what has been said and not previously responded to might follow, and we'd expect those would be brief.

ELIAS CJ:

Yes, thank you.

BLANCHARD J:

Just before you begin, Mr Gray, I think I should disclose that Mr Pickering the Commissioner is a close friend of mine. I didn't see the fact that he was a Commissioner as needing such a disclosure because it's just like an appeal from a Judge who happens to be a friend, but I noticed to my astonishment towards the end of yesterday afternoon, when I was finishing plying through the papers, that the Commerce Commission is actually relying on an affidavit that he swore. I've looked at the affidavit this morning and it didn't seem to me there was anything in it that should change my view, but I think I should put it on the record.

MR GRAY QC:

And I doubt that there will be a problem, Sir, but I do need to take instructions of course to be meaningful. Can I just indicate in the morning – at the end of the morning adjournment, or would you just like to pause for a second?

GAULT J:

Well, while you're on confessions, I have a feeling that I may have a residue holding of Telecom shares, it's only a 100 or two that didn't get away somehow and so that should be disclosed.

TIPPING J:

Me too.

MR GRAY QC:

I can't imagine that they're a problem and –

McGRATH J:

I am accustomed in such matters to disclose the fact that I am a personal friend of Dr Roderick Deane, but it all seems rather historical.

ELIAS CJ:

And my relationship with a superseded report, I suppose, should come into this, but I hadn't thought that it was material. I wonder do you want to take instructions before we get underway?

MR GRAY QC:

I've had a nod, Your Honour –

ELIAS CJ:

All right, thank you.

MR GRAY QC:

– Vodafone takes no objection to –

ELIAS CJ:

In fact, Mr Gray, is Mr Pickering's affidavit one of those that the Judge excluded?

MR GRAY QC:

I thought it was.

ELIAS CJ:

So there's an issue there as to whether it can be referred to anyway?

MR GRAY QC:

I don't understand there to be an appeal against the decision to exclude the affidavits.

ELIAS CJ:

All right, well she really –

BLANCHARD J:

Well that solves my problem.

ELIAS CJ:

– the Judge really did say that was because it was a submission, so I suppose it would be open to Ms Scholtens to put forward any matters of submission that are maybe usefully contained –

MR GRAY QC:

Indeed, Your Honour –

ELIAS CJ:

– it's just not evidence.

MR GRAY QC:

And that affidavit addressed a topic in respect of which both Vodafone and Telecom had themselves filed affidavits and we rather saw it as being an all-in or all-out situation.

ELIAS CJ:

Yes, all right. It's a messy enough case as it is thank you. Sorry Mr Hodder, did you want to – oh I am sorry we haven't taken the appearance – yes we have.

MR HODDER:

I was just going to say in terms of the Pickering affidavit – that was a response to one of ours and as I recall it Her Honour Justice Winkelmann treated it as being more submission –

ELIAS CJ:

Yes.

MR HODDER:

– so rather than proposing or incorporating her submission, I don't imagine we're going to refer to the affidavits in response.

ELIAS CJ:

Thank you. Ms Scholtens?

MS SCHOLTENS QC:

Yes, Your Honour, it was really filed in relation to a judicial review allegation about clarity in the determination which is no longer an issue, so one way or another I doubt it will be referred to at all.

ELIAS CJ:

Thank you, that's helpful.

TIPPING J:

Well I needn't disclose then that I played cricket with Mr Pickering.

ELIAS CJ:

It's not a risk I run.

MR GRAY QC:

May it please Your Honours, the structure of the submissions that I will make this morning are as follows. First I have some introductory comments setting the scene for the particular appeal in respect of which I am making submissions, and that's come to be called the "network modelling" appeal, and it arises from the decision of the Commerce Commission in relation to the 2003/4 year for which a TSO levy was fixed. Then I will move to look at the statute, the Telecommunications Act, looking at its history and purpose, its text, its structure, and then make submissions dealing with

what we say are the consequences of alternative interpretations of the statute. And it will be implicit in what I have said that we say this is an issue of statutory construction in the appeal and not a reasonableness review of what it is that the Commerce Commission said. The right of appeal, of course, is by – on a question of law only.

ELIAS CJ:

And does – in the point that you're addressing on your appeal, do your submissions also cover your response to the appeal against the determination of Justice Winkelmann?

MR GRAY QC:

To a large extent –

ELIAS CJ:

As to the first part?

MR GRAY QC:

– but not completely.

ELIAS CJ:

Yes.

MR GRAY QC:

There's a material distinction between the 2003/2004 year –

ELIAS CJ:

Yes.

MR GRAY QC:

– and then the subsequent two years. In the 2003/2004 year, the Commerce Commission decided for the first time that mobile technologies provided a quality of service capable of providing TSO services and modelled them. But we say modelled them in an inappropriate way. Then, as a result of, well, after litigation, the Commerce Commission held a conference for the subsequent years in order to consider how to model mobile technologies for subsequent years. At that conference, Dr Hird, a witness called by Telecom, raised a topic not notified on the

conference agenda which is, well – if you model mobile technologies in the ways we've been discussing, Telecom will not recover the hypothetical investment it made in the assets employed to provide TSO services, and that raises an economic issue. He then offered to provide more material, and did, and as a result of that the Commission, we say, did a flip-flop and said, oh we're not going to model mobile technologies at all, we're not going to include new technologies because to do so would be to decide that, to take decisions which might mean that Telecom doesn't recover its hypothetical investment and new assets at 2001. So that to the extent that we say the Commission should include mobile technologies and should recognise the unique or the different architecture of mobile technologies, my submissions are common to both appeals.

ELIAS CJ:

Yes.

MR GRAY QC:

When it comes to the question of whether a flip-flop was done and whether it was right to say that to move to mobile technologies risks stranding of Telecom assets and therefore behaving in a manner that doesn't promote dynamic efficiency, that's something which I'll make submissions on in response to my learned friend Mr Hodder.

ELIAS CJ:

All right, thank you.

MR GRAY QC:

I start by observing this, Your Honours: every Judge who has considered the question of TSO levies in both the '03-'04 and the subsequent years has concluded there's a problem. Justice McGechan decided that the issue was not a question of law but finished with the kind of aside that you sometimes see saying, "But we do need to stop and think about this". And His Honour said at paragraph 62 of his Judgment, "Some points raised," and went onto say, "perhaps warrant thought". He described the nature of the decision to model mobile technologies in the way the Commission had as "increasingly unrealistic", and invited the Commission to consider whether the increasing unreality points towards some revisiting. So in quite a powerful conclusion to his Judgment he really invited the Commission to go back and have another look at it, and that's found at paragraph 62 of his Judgment.

In respect of the two subsequent years, in the Court of Appeal the President, Justice William Young, concluded that the Commission had erred in law and that the arguments for the Vodafone methodology were more formidable than the Commission had recognised. He was of course in the minority. For the majority, Justice Arnold, who had concluded that the process by which the Commission had considered the matter was robust, and for that reason it would be wrong to interfere with it, nevertheless said at paragraph 114 of his judgment, "The scorched node methodology will require periodic review or reassessment and perhaps ultimately replacement". He went on to say, "I do not think it reasonable to expect the Commission should on the first occasion abandon its previous response, previous approach". So what His Honour was saying was, well the process has been a good one, in time something will have to be done about it, but I don't think it should have to be done the first year mobile technologies are available and appropriate.

Justice Glazebrook at paragraph 148 said, "There may well come a time when the Commission should abandon the scorched node approach". And at paragraph 153, "However, a point may well come (and relatively soon) where the Commission will be obliged as a matter of law to reconsider". And she was referring to the mobile technology that was available. In the High Court in respect of the subsequent year, Justice Winkelmann said at paragraphs 67 to 75, "Objectives standard of efficient service provider costs" and she went on to say, "are not more than the unavoidable net incremental costs". And she concluded, "It is unlikely that the model developed by the Commission was every well designed to function as a cap." And by that she's referring to the way in which the costs of providing service by radio rather than wires can cap the amount that Telecom could recover. Her Honour went on to say, "The model also assumes a level of initial capital investment by Telecom that was not made. The Commission has ceased calculating net cost." And finally, "The Commission has excluded from its consideration the possibility that new technology and net cost was not intended to be more than Telecom's actual cost" and she was satisfied that the Commission has erred. So every Judge who has considered the matter has concluded that the approach by the Commission, which treats, in respect of 0304 mobile technology as proxy for wire-copper pairs, or for other radio technologies which replicate more closely what a copper wire does, but providing only point-to-point communication, and its decision both in the way it models mobile technology and then later to exclude it completely was wrong and would not be sustainable to the extent that Justices Arnold and Glazebrook in the Court of Appeal decided that it would be wrong for the Courts to interfere in the case before them. It

was because the process by which the Commission had reached its decision was a careful one that it was reasonable not to interfere with it, at least not so soon. But Justice Glazebrook concluded explicitly that it would need revisiting quite soon, and Justice Arnold thought it might require revisiting sometime further into the future. And of course to that we say, well this is not a reasonableness review, it's an error of law case, and it there's an error of law, there's always an error of law both at the beginning and subsequently.

Now –

TIPPING J:

Is the error of law essentially not either appreciating or applying the definition of net costs?

MR GRAY QC:

Misconstruing the statute, it's, I'll come to it in detail of course –

TIPPING J:

Yes.

MR GRAY QC:

– but it's not considering the incremental capital employed by Telecom in providing the service, and we say that the practice, the approach of hypothetically valuing Telecom's legacy assets likely to have already been fully depreciated as if they were new at 2001 costs, is not measuring incremental capital, and that in construing the definition of net cost in section 5, but the Commission and Justice Arnold have concluded that the word "unavoidable" has no meaning, adds nothing to the definition, and therefore doesn't affect the construction of net cost at a whole.

McGRATH J:

Is it your position then that the model was lawful until mobile technology became feasible, and at that stage it became unlawful?

MR GRAY QC:

Your Honour, more accurately we would say it was never lawful, but it didn't matter until mobile technology became available.

ELIAS CJ:

Isn't there a – doesn't the Commission decide that it was efficient delivery, the wire network, copper wire network, before the determination that's in issue here? There was an earlier determination –

MR GRAY QC:

Yes.

ELIAS CJ:

– that it was most efficient, and there's no appeal from that?

MR GRAY QC:

The Commission, there are within the deeds between Telecom and the Crown for the provision of TSO services, quality of service parameters and what the Commission –

ELIAS CJ:

Why do we need to go into that though? That is a question, why, if you're saying there's an error of law in that the statute hasn't been properly applied, why is it necessary to go beyond the determination and the statute?

MR GRAY QC:

Because it's only to answer this question, Your Honour.

ELIAS CJ:

Yes.

MR GRAY QC:

Because until mobile technology was accepted as being capable of providing the appropriate quality of service –

ELIAS CJ:

I see.

MR GRAY QC:

– it wasn't modelled.

ELIAS CJ:

Yes.

MR GRAY QC:

And the change that occurred in 2003 and 2004, was the Commission decided for the first time that mobile technology was capable of providing the correct quality of service.

ELIAS CJ:

Yes.

MR GRAY QC:

And so for the first time it became necessary to consider it. Before then the Commission considered that the correct quality of service could be provided by copper wire, by a technology called wireless local loop, which is a pair of transmitters going backwards and forwards, and by another wireless technology called multi-access radio, which did the same thing but to more than one person simultaneously.

TIPPING J:

So once mobile became capable, then you say it became an error of law not to factor it in?

MR GRAY QC:

Yes.

TIPPING J:

It's as simple as that really.

MR GRAY QC:

And not to do it recognising what mobile technology does, which is different from copper wires and different from multi access radio and wireless local loop. Until then, Your Honour, yes, the Commission had decided that copper wires were efficient, but partly that decision was based on a recognition that Telecom was entitled to receive a return of a hypothetical investment in copper wires made in 2001. So although these copper wires had been in place, principally for a long, long time, probably had already been fully depreciated, for the purpose of its modelling the Commission regarded them as having been built for the first time in 2001 and the biggest part of

the cost is digging trenches. Vodafone doesn't know where all theses clusters of commercial non-viable customers are, but not all of them are up and down steep hills, some of them are in Canterbury where the soil is stony and where it costs a lot of money to dig a trench through the stones. It's not particularly difficult to take copper there, it's just expensive, and it becomes more expensive as time goes on. So the later you model the digging of a new trench, the more expensive it becomes, the more customers become commercially non-viable. If commercial viability is assessed by reference to the need to both provide a return of the capital employed and a return on the capital employed.

ELIAS CJ:

But are we concerned with that? You're saying there were errors at the outset and that's probably what Winkelmann J is saying in saying that it was perhaps problematic methodology from the start, but we're not concerned with that historic determination beyond the fact that, at the time, the Commission determined at that time it was an efficient technology.

MR GRAY QC:

Correct.

ELIAS CJ:

Yes.

MR GRAY QC:

Correct. Perhaps the way just to conclude it, Your Honour, is what the Commission has most been concerned about is dynamic efficiency, and the theme that runs through its position initially and now is that unless an investor knows at the time of making an investment that they will both get a return on the investment and also a return of it they won't invest. And for that reason it's necessary to make a return of the hypothetical investment to incentivise TSO providers to provide the infrastructure required to provide the service. And that is said to be a dynamic efficiency concern, and where it is said by the Commission there is a clash of elective efficient and dynamic efficiency, because it's a longer-term, forward-looking concept dynamic efficiency prevails, so that even though it costs more to do what the Commission has decided to do, the Commission's case is that it should decide to do it, because only by doing that will firms be incentivised to build the infrastructure to provide TSO services. And so that's the basis on which the Commission had concluded that it

was efficient to rely on copper wires, and that's the factual error that we'll come on to make submissions about in the course of the day.

ELIAS CJ:

Because does it, does it necessarily follow that if you're concerned with dynamic efficiency, you start with the historic technology? You'd say no?

MR GRAY QC:

No, we say no, and we say –

ELIAS CJ:

I mean, you're not against an approach that looks at dynamic efficiency?

MR GRAY QC:

Not at all.

ELIAS CJ:

No, that's all right, thank you.

MR GRAY QC:

If a firm invests $10 in technology to provide TSO services, then we understand that Telecom and the Commission say a firm won't do that unless it believes it's going to have it returned and to make money on it in the meantime. We say that, but when you haven't spent $10 and when the amount that you spent in the past was $2, it's just that $10 is the cost of building now, and it was never spent, then it's not efficient to require a return of it. Especially not when there's an alternative and cheaper way of doing the job.

BLANCHARD J:

Do we know why the Commerce Commission in 2001 essentially abandoned historic cost?

MR GRAY QC:

It construed the statute as mandating economic cost rather than historic cost, and it concluded, at the time, that it might be difficult to assess historic cost and there were all sorts of opportunities for, well, difficulties in investigating when depreciation had

occurred and at what rate and whether it had been completed. So it adopted for an approach based on a modelling of modern equivalent assets.

And we say there's one other thing to bear in mind in considering telecommunications as a network industry. Both Telecom and the Commission argue by analogy with network industries such as electricity lines, water pipes, gas pipes and the like, and of course many of the concepts that we're talking about in relation to telecommunications are relevant also to consideration of those industries. But there are important differences between telecommunications and those other network industries. For those other network industries, the network is static. There's no alternative. Technology change doesn't mean that a water pipe can be replaced with something different. You can't transport virtual water electronically. So a water pipe network will remain a water pipe network. An electricity line network, by and large, remains an electricity line network. Cables get better, but the lines remain the same. For telecommunications that is not the case, there is a high rate of technology change and there is substitution of copper wire by wireless alternatives.

The only similarity between telecommunications and other networks is the fact of a network, but otherwise those other industries, those other technologies are static and not dynamic. Not subject to change and, what's more, the thing that is being considered usually in relation to those industries and networks is price control and there's a circularity between asset value and price and so the issue becomes different. In this case we're not considering price control, we're trying to estimate the cost of providing an increment to a national service and the issue is much more complex. It starts with –

ELIAS CJ:

Sorry, do you, so do you say from that some of the Commerce Commission's reliance on other regulatory regimes is astray because those regimes are concerned with regulation of the industry and price setting, rather than the specific exercise that the statute requires to be undertaken here?

MR GRAY QC:

Yes.

ELIAS CJ:

Yes.

MR GRAY QC:

Yes. Unlike with those other industries, here we start by asking, which customers are commercially non-viable? So the first part of the decision is for which customers or clusters of customers in the country does the line rental that Telecom charges, it's now about $50 a month I think, not cover the cost of providing free local calling. That's the first point and, of course, the more expensive the costs, the more customers are commercially non-viable. The cheaper the costs are, the smaller the number of customers that are commercially non-viable.

The second question then is, well, which of the capital employed in the Telecom network is incremental, in the sense of being additional to the network that would exist anyway if service was only provided to commercially viable customers. So there's an important assessment to be made of which parts of the capital employed are incremental because they wouldn't otherwise be employed, and then, finally, what costs are unavoidable because there's no alternative way of providing the service which is cheaper, so it's not possible to avoid the cost. And remember what we do know now is that the Ministry of Economic Development seems to have concluded that there is no net cost currently to Telecom with providing a service because there are other benefits that Telecom receives from being ubiquitous and from being the supplier around the country which ought to compensate it.

ELIAS CJ:

Is that something, I haven't –

MR GRAY QC:

It's a matter of history, Your Honour, it doesn't affect the statutory construction that you have to undertake.

ELIAS CJ:

No, and it isn't material, is it, to the judgments we're considering? I don't recall that jumping out at me?

MR GRAY QC:

No it's not, no, Your Honour's point is quite right, but I will come to make the point that this topic that the Commerce Commission has been grappling with, and no one pretends that it's found it easy or been able to do it quickly, is being addressed by other countries as well, and there's a trend towards movement away from economic

cost to a more accounting cost and a consideration of a depreciated direct cost when assessing, if you like, the opening value for assets employed in providing universal service.

With those preliminary submissions, I turn to history and context of the issue, and in my submission the starting point is the Ministerial Inquiry into telecommunications, which was published on the 27th of September 2000. It is found in Vodafone's case at volume 2 under tab 27, and at page 715.

ELIAS CJ:

Why is it – well, you'll tell us why it's necessary to go here, because on the issue that we're concerned with it is superseded.

MR GRAY QC:

Our submission, Your Honour, is that the Telecommunications Act was drafted following this Ministerial Inquiry and that this Ministerial Inquiry is the most authoritative source for understanding the context of the issue, the purpose of the legislation and the things that the legislation was intended to achieve. So we say that it's relevant to construction of terms used in the statute.

GAULT J:

Mr Gray, I always have this discomfort when one listens to argument about the interpretation of the statute. It starts with all manner of background and peripheral factors, when it would be terribly helpful to have the particularly statutory provisions that are to be interpreted.

MR GRAY QC:

That discomfort, Sir, I can deal with by starting with the statute. It's just that as a, I suppose, chronological sequence, I was looking to set the scene. Vodafone's bundle is in four volumes. Volume 1 contains, under tab 1, section 5 of the Interpretation Act, which Your Honours will be familiar with, and under tab 2 the Telecommunications Act.

McGRATH J:

Is this in, that that happens in the – still in the current, currently in this form?

MR GRAY QC:

There are some subsequent amendments which are not material to this appeal –

MCGRATH J:

Fine, thank you.

MR GRAY QC:

– or either of these appeals.

MCGRATH J:

That's all right, I had noticed there were some amendments, yes.

MR GRAY QC:

Your Honours will see that the purpose of the Act is described in section 3, and the main purpose was to regulate the supply of telecommunications. So TSO services are not the main purpose, they're an ancillary purpose. In the overview of the Act, at section 4, the TSO is provided for at subsection (f), and in this Act provisions about the supply of certain telecommunication services under TSO instruments, the enforcement of the instruments and contributions payable by certain telecommunication service providers to suppliers of the services, are set out in Part 3 and it is Part 3 that deals with TSO services. The interpretation section is section 5. Deemed TSO instrument is defined and has the meaning set out in section 71, so it's defined by reference to section 71. We will come to it, but briefly the point to be made is Telecom in its submissions make as much of a social compact for the provided, provision of these services. There are two provisions dealing with the, with TSO services. One is section 70 and one is section 71. Section 70 deals with new TSO services, section 71 deals with what was the old Kiwi Share Obligation included in the constitution of Telecom on privatisation and we say there's a difference between them.

End-user in section, in page 7, in section 5 is important. Your Honours may recall that in the Commerce Act, the persons for whom the Act is said to benefit are called "consumers", but over time the courts have explained that their understanding of consumers for that legislation involved not only final consumers but also intermediate consumers who consumed for the purpose of providing additional services. There's a question about why Parliament has chosen to refer to the beneficiaries of the legislation in this case as end-users and whether their focus is even more firmly on

final consumers than intermediate consumers, and whether that's indicated by the choice of the phrase "end-user" rather than the word "consumer".

McGRATH J:

Sorry where does end-user appear?

MR GRAY QC:

It's in the definition section, Your Honour, in section 5, and it also appears in the "competition purpose" provision, which is section 18.

Over at page 8 of the statute is the definition of KSO and it means "the obligations that were set out in clause 5 of the first schedule to the constitution of Telecom" and it includes correspondence, being a letter of 1 October 1997 and responses in September of 1999. Your Honours will have seen that in the 0867 appeal in which my learned friend Mr Hodder appeared.

"Liable person" – that's the definition of Vodafone and all the other people who are providers of telecommunication services and who have to make a contribution to Telecom for its cost of providing the services.

"Line" – and we say this definition is important because it enshrines the technology neutrality in the Act. It doesn't mean just copper wire, but it's copper wire or a conductor of any kind used or intended to be used for the transmission or reception of signs, signals, impulses and the like and includes poles. So this is an Act, we say by reference to the definition of line and other definitions, which is intended to contemplate all manner of present and future technologies and not at all be limited to those existing at the time the legislation was drafted.

Probably the most important definition is net cost. And it's to be noted that that means unavoidable net incremental costs and it's costs to an efficient service provider, so there are four key issues which need to be determined when looking at that definition. First, efficient service provider. Second, incremental costs. Third, net incremental costs, and fourth, unavoidable incremental costs. It's a complex definition and we say that it shows that Parliament intended it was only the barest of extra costs incurred in providing the services which were to be reimbursed by being charged to liable persons and being the subject of a levy.

"Original KSO" follows up from the earlier definition we saw of KSO, and it means both the constitution of Telecom and the exchange of correspondence between the parties. Over the page, "telecommunication", and again this is relevant to the technology neutralities submissions that Vodafone makes. "The conveyance by electromagnetic means from one device to another". Completely technology neutral, the conveyance can be by electronic impulses on wires or by wireless signals. But not broadcasting. And of course what distinguishes telephony from broadcasting is that broadcasting is to the world whereas telephony is broadcast – is transmission from one person to another.

"TSO instrument or telecommunication service obligation instrument" means an instrument declared to be a TSO instrument under section 70 and a deemed instrument. And Your Honours may recall I foreshadowed a distinction to be drawn between section 70 TSO instruments and section 71 TSO instruments.

Now section 18 is important. That sets out the purpose. Your Honours will note that section 18 is included within Part 2. Part 2 deals with identifying services which are to be regulated, and it begins at section 81 with the words, "The purpose of this Part and Schedules 1 to 3 is to promote competition." Section 18 applies also to Part 3, it's included specifically by a reference in section 84. That's why we come to have a look at it. You will note that it has a long-term focus, the long-term benefit – the beneficiaries are end-users within New Zealand "by regulating, and providing for the regulation of, the supply of certain telecommunication services between providers. So to the extent that that purpose regulates supply between providers", arguably it doesn't strictly apply to the provision of TSO services between Telecom and end-users but instead deals with only the ultimate benefit to end-users, and so is the springboard for a preference to dynamic efficiency concerns.

Subsection (2), "In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications for the long-term benefit of end-users within New Zealand, the efficiencies that will result, or will be likely to result … must be considered." And again it's not a terribly comfortable fit within section 84, because the provision of TSO services don't immediately seem to result in competition between, competition in markets in New Zealand. We say that this subsection is relevant, but by a more nuanced and less direct process. We say that what subsection (2) means in the context of these cases is that a firm like Telecom ought not be able to burden its competitors with an

increased unnecessary cost for providing services because that burden impairs their ability to invest themselves, and to compete in other markets.

We then come to Part 3, which is found initially at section 70. You'll note that section 70 provides for the declaration of TSO instruments, it may not otherwise be supplied for services that may not otherwise be supplied on a commercial basis, or is not considered by a Minister to be affordable to groups of end-users. Your Honours will note at section 70, subsection (3)(b), the process by which TSO providers are identified, and the way in which a decision whether or not to declare a TSO instrument is to be made. And that is to be distinguished from section 71, which deals with the deemed TSO instrument, which is the successor to the Kiwi Share Obligation and is the universal service obligation now provided for in the exchange of correspondence between the government and Telecom in 1996 and 1997, and the deed. And you'll see at section 70 that that –

ELIAS CJ:

So does that mean that it imports the TSO, the actual TSO instrument, without requirement for the sort of process specified in section 70 to be followed?

MR GRAY QC:

Yes it does. So when Telecom makes submissions that TSO services are provided pursuant to a voluntary compact, we say, no they're not. They're not provided pursuant to a voluntary compact in the way that section 70 TSO services would be. They are a legacy deriving from the terms on which Telecom was privatised and its shares were sold to the public. That when the public came to buy shares in Telecom they understood that Telecom would be required to provide universal service. And that arrangements have evolved over time with the exchange of letters in 1996 and 1997 and a new deed.

ELIAS CJ:

Does the universal service arise out of the deed, not – it's not imposed by statute?

MR GRAY QC:

No, Your Honour's right. It arises out of the constitution of Telecom which is now expressed in the deed.

ELIAS CJ:

Yes.

MR GRAY QC:

But section 70, I'm sorry 71, 72 and 73 are careful to preserve the obligation contained in the constitution of Telecom, so that if the TSO, which is deemed by section 71 to be at TSO, falls away the obligation in the constitution remains. The next provisions deal with compliance with TSO instruments. And their net cost is provided for from section 83 onwards. Section 83 deals with accountants verifying numbers, and section 84 sets out the considerations for determining net cost. Your Honours will note at section 84, subsection (1), that (a) and (b) are matters which must be taken into account, they are mandatory considerations. First off "the range of direct and indirect revenues and associated benefits derived from providing telecommunication services to commercial non-viable customers". In other words, you may lose money on providing local services, but if you can make money by providing long distance services, broadband services, then the benefit of being able to derive those additional revenues must be taken into account.

And then at 84(1)(b), "the provision of a reasonable return on the incremental capital employed in providing the services to the customers". And Your Honours will see when we go back to the Ministerial inquiry report that the recommendation made there was that there not be a return of capital, and this is one way in which the legislation differs slightly from the report. But it is incremental capital.

TIPPING J:

But it refers to a return on.

MR GRAY QC:

Not a return of.

TIPPING J:

Yes.

MR GRAY QC:

Yes. This provision does not require a return of incremental capital.

TIPPING J:

No.

MR GRAY QC:

And it certainly doesn't require a return of capital not invested but representing the hypothetical value of the assets employed in providing the service. Subsection (2) sets out some permissible factors at (a), "may choose to not include profits from new telecommunication services..." In other words, when we're doing work under section 84(1)(a) and considering services from other services, we may choose not to consider revenues derived from services which are new and where the investment is new and hasn't been fully recovered by depreciation or otherwise. 84(b) "must not include losses from other services" –

ELIAS CJ:

Sorry. You're saying that subsection (2)(a) scoops up the revenue in 84(1)(a)?

MR GRAY QC:

Yes.

ELIAS CJ:

There's a – yes.

MR GRAY QC:

It modifies.

ELIAS CJ:

Yes.

MR GRAY QC:.

84(2)(b) says you can't consider losses that you make on other new services, and 84(2)(c) says you must consider the purpose set out in section 18. So it's a mandatory consideration, but it's a consideration, it's a matter of degree the extent to which the Commission must achieve section 18. Subsection (3) –

TIPPING J:

Is there any argument about that not having been taken into account?

MR GRAY QC:

We say it's not taken into account properly.

TIPPING J:

But that's a –

MR GRAY QC:

But it has been taken into account.

TIPPING J:

That's a qualitative matter.

MR GRAY QC:

Precisely. Yes, the Commission was aware of that obligation and it refers to section 18 for purpose in its determinations. Section 84(3), Telecom has to comply with requirements of the Commission, and section 84(4) defines established and new telecommunication services. Section 85 doesn't apply in this case. The Commission hasn't done it and no has said the Commission should have, it just says that the Commission can weight different revenue streams differently if it wishes to. Section 86 onwards deals with the process by which the Commission is to develop a draft determination, what should be in it.

ELIAS CJ:

What do you make of, in your argument, I can't remember, of 84(4), the distinction between those? Is that relevant to your argument?

MR GRAY QC:

No. We say 84(4) relates back to 84(2)(a) Your Honour.

ELIAS CJ:

Oh yes, yes.

MR GRAY QC:

In other words it's a question of which services are established ones and which are new.

ELIAS CJ:

Yes, I see.

MR GRAY QC:

But we don't otherwise make submissions by reference to it. 86 and onward deal with process and it's the familiar process of a draft determination, what the draft determination has to include, and that's set out in 88. The power to hold a conference at 89, and then the process by which a determination is issued and the matters to be included, and those provisions are not the focus of close attention in these appeals.

So Vodafone's appeal is that there is an error of law. Because the Commission has not calculated the net cost appropriately, it has included avoidable costs, it's included costs for the provision of service by copper wires when some of those costs could be avoided by the provision of service by mobile technology, and it's done that because it's considered that unavoidable has no meaning and adds nothing to the definition. That it has misconstrued the phrase "efficient service provider" by concluding that an efficient service provider would require a return of a hypothetical investment not made in trenches in copper wires, valued as if they were built in 2001, but in fact having built, been built years earlier, and the cost of them probably having been recovered, substantially at least, by depreciation.

TIPPING J:

Is it the artificiality of starting from a false premise, if you like, that is at the heart of this argument?

MR GRAY QC:

Yes. Because of that artificiality, the Commission became committed to its model and to what it calls "net present value equals zero", which you will see littered through Telecom's submissions and to a lesser extent the Commerce Commission's submissions. Because of that false initial premise, the Commission has concluded that its model requires a return to Telecom of the hypothetical cost of building its trenches in 2001. That not to do that impairs dynamic efficiency because it removes incentives to providers to invest. And because it therefore needs to return that cost, it can't allow the technology included in the model to be superseded before the investment has been returned. So it's driven to ignore mobile technology or, when it did in 2003 and 2004 include mobile technology, to include it in a way which treats it

as a replication of, or a proxy for, copper wires, rather than to treat it by reference to its own distinctive architecture and technological capability. And so we say all of Your Honour Justice Tipping is right –

ELIAS CJ:

Is that the, is that the approach that imposes it on the core network?

MR GRAY QC:

There are two components, Your Honour –

ELIAS CJ:

Yes.

MR GRAY QC:

– the Commission scorched the access network –

ELIAS CJ:

Yes.

MR GRAY QC:

– which is the bit between the last switch –

ELIAS CJ:

Yes.

MR GRAY QC:

– and everyone, but I have said in submission that the Commission, when it did include mobile technology in 2003 and 2004, did so in a way which ignored its own technological capabilities and its architecture. Mobile technologies are an overlaid network that exist in parallel with the wire network –

ELIAS CJ:

Yes.

MR GRAY QC:

– they deliver calls, the network delivers calls, through its own, sometimes wire, sometimes wireless pipes, if you like, and they connect with the core network at the

most convenient point for them to connect to the core network, usually not at the very local switch, and it's because employing mobile technology, we say properly, requires connecting the call back to the core network at places convenient to mobile technology, that part of the core network will not be employed –

ELIAS CJ:

Yes.

MR GRAY QC:

– doesn't mean it will be stranded necessarily, because those parts of the core network might well be employed providing other services, either to commercially non-viable customers or to commercially viable customers, but we say it, that we –

ELIAS CJ:

It could conceivably be wholly overtaken and stranded however?

MR GRAY QC:

Yes.

ELIAS CJ:

In theory, yes.

MR GRAY QC:

Yes. Another error which we say the Commission's adoption of its model has forced is that it accepts that Telecom has two networks, a wire network and a mobile network. The definition of network in the Act doesn't permit the telephony provided to say, this part of our assets are one network and this part's another. As long as they are interconnected, they are a network. And we say Telecom is a network composed of some mobile assets and services and some wire assets and services, but it is one network and we say that it's artificial to say to a provider like Telecom, we allow you to provide this service by using one part of your network and we say that's especially the case when that part of the network happens to be older, already depreciated and more expensive.

I mean, in the beginning of mobile, it offered an additional feature that wire telephony didn't and that was mobility. Firms were able to charge a premium for that additional feature and that additional feature became, and it was initially, expensive to provide.

Over time technology has dealt with costs, so that costs are driving downwards and will continue to. It's possible to provide services to fixed locations using mobile technology without at the same time providing the additional feature of mobility, so that employment of mobile technology doesn't necessarily mean that you need to offer a mobile service.

TIPPING J:

Mr Gray, in the definition, and I suspect that net, the definition of net cost, is pretty well at the heart of all this, is that a fair comment?

MR GRAY QC:

Yes it is, Your Honour.

TIPPING J:

Yes. Is there or is there not a link between the concepts of unavoidability and efficiency. In other words, may the word unavoidable have to take some colour from the concept of the service provider being efficient? In other words, putting it more bluntly, if, if an efficient service provider would not avoid, if you like, certain costs, then is that not a reasonable reading of the definition that the thing must be seen a composite whole?

MR GRAY QC:

Right.

TIPPING J:

The fact that it may be literally avoidable may be one thing, but if it's not efficiently avoidable, that may be another thing.

MR GRAY QC:

Well, we say if, I accept Your Honour's proposition that all of the, first the definition of net cost probably lies at the hub of the appeals. Second, that all of the words interact with each other and can't be read in isolation from each other, and I do accept, Your Honour, therefore that unavoidable and efficient need to be considered alongside each other and colour each other, but both ways.

TIPPING J:

Yes.

MR GRAY QC:

Our starting proposition is that an efficient service provider will not incur unavoidable costs.

TIPPING J:

Will not incur avoidable costs?

MR GRAY QC:

Not – I'm sorry, yes, Your Honour's right, not incur avoidable costs. What the Commission said in its early work is, we do need to recognise that investment in technology infrastructure in this field is very expensive and investment decisions have a long life, and if an investment is made in year one and in year five there's a new technology available which is cheaper, we do need to recognise that at the time the investment was made it was the right decision and if the investment was made for the purpose of providing TSO services, then we do need to allow the investor to expect to recover that investment. Even though something new and better's come along.

So the Commission has grappled with this idea that even though efficiency gains are being made continually, we can't expect the TSO provider to throw away their entire network every year or two and to rebuild with whatever is the newest, cheapest whiz-bang technology that becomes available. But we say, Your Honour, that's fine, to the extent that an efficient service provider would invest in assets in year one of a TSO obligation for the purpose of providing the TSO obligation. It is reasonable to expect the provider to plan to recover that cost.

TIPPING J:

Is this where the artificiality of deeming the copper network to be constructed in 2001 bites?

MR GRAY QC:

Yes. If Telecom had gone out and dug a heap of trenches, and laid copper wire, and the Commission has decided that's what an efficient service provider would have done, at that time, then we'd understand the arguments that the cost of doing it should be recovered, and it's recovered by what's called the annuity tilt, and one modest difference between the parties is Telecom treats NPV=0 as a guarantee of

return, whereas the Commission says, no, you make your assessment at the beginning, and if –

TIPPING J:

I'd rather not be distracted by that, Mr Gray, if you don't mind.

ELIAS CJ:

Is it –

MR GRAY QC:

Okay, sorry. One of the burdens of having been in this area for so long.

ELIAS CJ:

Is it, though, the fact that 2001, the position is that 2001, that in fact it was historic, even at 2001, exacerbates matters, but it's not the total answer is it? Because I thought that on your argument, adopting the 2001 position itself is not to give effect to the statutory formula.

MR GRAY QC:

No, Your Honour, we do accept –

ELIAS CJ:

You do accept that.

MR GRAY QC:

– investments made for the purpose of providing TSO services should be returned.

TIPPING J:

But this was not an investment made in 2001?

MR GRAY QC:

Correct.

TIPPING J:

That's the key point isn't it?

MR GRAY QC:

Yes. And it's investments made in 2001 which the Commission decides an efficient service provider would make.

TIPPING J:

But if it wasn't even made in 2001, you don't need to –

MR GRAY QC:

That's the frustration.

TIPPING J:

You can't go down that line, is the argument?

MR GRAY QC:

That's the argument, Your Honour. That it is not efficient that the Commission's misconstrued the statute when it says that the statute requires it to ensure that Telecom receives a return of a hypothetical investment in copper and trenches which it did not make in 2001.

BLANCHARD J:

And you're saying that Vodafone's failure to object to that, by way of appeal in 2001 and 2002, is not fatal because this is a question of statutory construction?

MR GRAY QC:

I say that. And I say also that it was never clear the extent to which the annuity tilt provided by the Commission was intended to return to Telecom the investments that the Commission decided it had made, but that Vodafone always expected that when the Commission decided that mobile technologies were capable of providing TSO services that they would be included. And it did not become clear to Telecom until the 2003/2004 determination that mobile technologies were not going to be modelled in a way that reflected what mobile technologies do.

BLANCHARD J:

Sorry you said Vodafone, I'm sorry you said Telecom, you meant Vodafone?

MR GRAY QC:

I'm sorry, I meant Vodafone, Your Honour, forgive me. That –

McGRATH J:

If you just say it again, they're not clear to Vodafone that...?

MR GRAY QC:

When mobile technologies became capable of providing TSO services, that they would be included in a way which did not reflect the existing overlaid network and the distinctive network architecture –

ELIAS CJ:

Do you mean that it wouldn't be, that it wouldn't reflect the capacity of the mobile technology but would be shackled to the existing –

MR GRAY QC:

Yes, it would be –

ELIAS CJ:

– the existing network?

MR GRAY QC:

It would be mis-modelled and –

ELIAS CJ:

Yes.

MR GRAY QC:

– and treated as a replication of copper wires, and that, in addition, in 2003 and 2004, Vodafone and Telecom both had networks in place which could have provided, not all of, but some of the TSO services. They were already built. No incremental capital would have been employed, any incremental cost would have been minor, because it would have arisen from the employment of resources already built other than for the purpose of providing TSO services. And we say it wasn't until 2003 and 2004 that Vodafone saw that that was the way Commission –

McGRATH J:

Now is this submission headed at any suggestion you accepted the position, or something of that kind? Is that what that submission suggests?

MR GRAY QC:

Yes. Yes.

McGRATH J:

But that could not have any legal effect, could it, given that there is an annual reappraisal?

MR GRAY QC:

I, with respect, Your Honour, Justice Blanchard put to me, "Well if it's an error of law, it's an error of law, and it always is, so that the fact that you didn't appeal by way of question of law in respect of earlier determinations, is not determinative anyway". And I accepted –

BLANCHARD J:

Well, I wasn't adopting that necessarily –

MR GRAY QC:

Oh, I see.

BLANCHARD J:

– I was just seeing if that was your argument.

MR GRAY QC:

I understand that, Your Honour, but I also wanted to explain why it was that Vodafone did not appeal until 2003/2004.

TIPPING J:

You didn't think they were going to do what they did?

MR GRAY QC:

No, Your Honour, we thought –

TIPPING J:

That's certainly it in a nutshell.

MR GRAY QC:

Well, Vodafone saw a technology-neutral statute. It saw definitions and provisions designed to ensure that costs which were levied, were minimised, were only those genuinely, efficiently, incurred from the employment of incremental capital and unavoidably incurred, and it expected that when lower-cost technology became available –

TIPPING J:

No, well, unless this is helpful to you, otherwise you needn't, you know, for my purpose.

ELIAS CJ:

Can I just ask, because it is just niggling with me – I understand that your argument is not a scorched earth argument, but of course you're a provider, there must be an argument that, and maybe nobody's putting it forward, but I'm just trying to think of the logic of it, there must be an argument the statute does require a scorched earth assessment.

MR GRAY QC:

In early submissions to the Commerce Commission before the first determination, Vodafone adopted that position.

ELIAS CJ:

Yes.

MR GRAY QC:

The Commission went through a complex, a robust process –

ELIAS CJ:

Yes.

MR GRAY QC:

– in which it said, "Well you can either model everything from the bottom up and just see its actual cost –

ELIAS CJ:

Yes.

MR GRAY QC:

And you can re-optimise the entire network every year, because that's what the statute means.

ELIAS CJ:

Yes.

MR GRAY QC:

But if you do that, it's too tough on TSO providers, because they do make their investment decisions there and expecting their investments to last for a period and the risk of asset stranding is too great and the –

ELIAS CJ:

Why don't you just provide for that with your weighted average cost of capital and the risk factor that's built into that?

MR GRAY QC:

With respect, Your Honour, I think it's the annuity tilt –

ELIAS CJ:

Oh yes, yes.

MR GRAY QC:

– that achieves the early repayment –

ELIAS CJ:

Yes.

MR GRAY QC:

– to compensate for the greater risk.

ELIAS CJ:

Yes.

MR GRAY QC:

When we come on to 2004 to 2006, one of the things the Commission noted when it accepted what Dr Hird said for Telecom is one way of dealing with Telecom's

arguments that its assets are stranded is to adjust the annuity tilt so that more of the investment is returned earlier, but they say that in the end that amounts to the same thing.

BLANCHARD J:
You'd never know how much to tilt it –

MR GRAY QC:
No.

BLANCHARD J:
– because you don't know when the new technology's going to arrive.

MR GRAY QC:
Well, there are economists who specialise in that sort of thing, but yes.

ELIAS CJ:
But everyone's in that –

BLANCHARD J:
But how could they possibly know, it's not a matter of economics, it's a matter of the engineering.

MR GRAY QC:
Yes, an expert assessment.

ELIAS CJ:
It is, though, a matter that's common to all network providers, so there must be some sort of working adjustment that applies in the industry.

MR GRAY QC:
There are models and they are, I mean they're informed estimates.

ELIAS CJ:
Yes.

MR GRAY QC:

You can't know, but you can make an estimate, and you apply a tilt on the basis of the estimate you make at the time the investment is made. And if in time your estimate proves to be on the high side or on the low side, then there are gains and losses but you live with those.

ELIAS CJ:

Yes.

MR GRAY QC:

We had addressed the statute in order to hopefully more clearly understand and deal more quickly with the Ministerial Inquiry report and to see the extent to which the statute had given it effect to –

ELIAS CJ:

Well perhaps picking up on Justice Gault's, undoubtedly correct, point that sometimes trawling through history doesn't help, can you tell us what provisions of the statute are – the understanding is assisted by going to the legislative history, that would be helpful.

MR GRAY QC:

I can tell Your Honour what it is we point to –

ELIAS CJ:

Yes.

MR GRAY QC:

We start with, the report is found in volume 2 of the bundle of authorities under tab 27, it begins at page 715, the terms of reference are set out at page 719 and they focus on the desire that –

ELIAS CJ:

What tab are we looking at?

McGRATH J:

This is in the case on appeal, I think.

MR GRAY QC:

No, it's in the bundle, Your Honour – I'm sorry, it is the case on appeal, forgive me. Tab 27 in volume 2. In fact, I hope our references will be less than a troll because much of this deals with which industries and which parts of the industry need to be regulated and not all of it deals with universal service. At page 719 is the executive summary, it begins with a summary of the terms of reference, and the beginning point was that TSO services were wished to be cost effective and innovative. Bottom paragraph on that page, "To avoid anomalous overlaps between sector-specific regulations, it's essential that regulation cover different ways in which the same communication service can be provided." We then go to 725, which is a summary and sets out in tablet form what is discussed elsewhere. The term of reference was cost efficient and what the Inquiry resolved is that it felt there should be incentive for efficient investment in use of networks, cost-based pricing of designated services in the third line and under "innovative", second bullet point, "Efficient pricing to assist timely innovation." And then down under "Inquiry's approach", the fourth bullet point was, "A better-defined Kiwi Share Obligation." On page 729, 2.2, again the objective which is derived from the terms of reference is set out, and at paragraph 2 the Inquiry takes "cost-efficient" to mean services are provided at the lowest cost, then delivered to consumers at the lowest sustainable price.

Next paragraph, the requirement these services be delivered on an ongoing basis has important implications. The Inquiry takes this to mean that regulation should be forward-looking, robust, durable and consistent over time, and not sacrifice long-term gains for short-term considerations. Given the dynamism of the electronic communication sector, to be robust regulation should be technology-neutral.

On page 753 under the heading "3.3" is a discussion of convergence. The Inquiry was aware that services were converging and ways of delivering them were changing and expanding. The second paragraph, "Electronic communication services have historically been provided by stand-alone industries operating in distinct markets. Fixed wire, telephony, broadcasting, cable and wireless – the boundaries are eroding rapidly as a result of a shift to digital as opposed to analogue communications", and then at the next paragraph, again, a reference to technology neutrality and there being alternative ways of providing the same service. That third paragraph finishing in the bottom two lines. "Convergence is now a reality and is likely to continue to rapidly break down and blur distinctions between telecommunications, broadcasting and the Internet".

Now, the next part of the Inquiry deals with regulation. We say that the general approach of the Inquiry towards wanting to achieve technology neutrality and to ensure that New Zealand was able to take up technological changes as they occurred, so as to enjoy the efficiency gains, can be seen in its approach, but that's a general submission. The Kiwi Share Obligation is discussed from page 801. At 9.1 on pages 801 and 802 the Inquiry sets out the background, including its assessment of who were the possible commercially non-viable customers. At the bottom of 802, in the five bullet points, it set out what it understood the Kiwi Share Obligation should achieve, and Your Honours will note at the fourth bullet point, "... irrespective of the technology used, not increase in real terms its GST exclusive monthly rental for ordinary residential phone services provided that profitability is not impaired".

On page 803 at 9.1.1 there's a heading, "Telecom's Investment Programme", that's not as helpful to it as it might have been because it's dealing with the issue that was current at the time of the provision of internet services to rural New Zealanders, Your Honours have seen a bit of that in 0867.

9.1.3 on 805, "The cost of the Kiwi Share Obligation". There's a description in the first paragraph of the Kiwi Share limiting increases in monthly rental and the extent to which that affects Telecom's ability to recover the cost of providing service. The second paragraph, "For any individual residential access line, these constraints involve a net cost for Telecom when the revenue generated by the line is insufficient to cover the costs of maintaining that line and paying any interconnection charges arising from that line". Now Your Honours will note that what the Fletcher Inquiry contemplated was not a return of investment at all, but compensation for direct costs. The bottom paragraph is informative, "Until recent information disclosure obligations" – "Under recent information disclosure obligations, Telecom will shortly be releasing an estimate of the losses it incurs in performing its Kiwi Share Obligations in loss-making areas. A preliminary estimate provided by Telecom is around $100 million per annum. This has been calculated by Telecom using the methodology of the disclosure regulations, which excludes some revenue derived from customers of Telecom's fixed loop network. The estimate also includes a return of capital that may have no recoverable value of –

TIPPING J:

On capital?

MR GRAY QC:

On capital, I'm sorry, thank you.

TIPPING J:

Not of.

MR GRAY QC:

Yes, a return on capital that may have no recoverable value if Telecom abandoned its customers in loss-making areas. The $100 million may therefore be seen as an upper estimate of the amount by which Telecom could increase its annual pre-tax profit in the complete absence of the KSO. It's interesting that the TSO costs estimated by the Commission got pretty close to that $100 million in fact. And then over the page at 808, and the bottom paragraph, the Inquiry concluded that a tender process for the provision of the services didn't have much to offer New Zealand.

And what we take from that report is the commitment to technology neutrality. The awareness that telecommunications is a rapidly evolving industry in which technology changes will yield reduced costs and efficiency gains. A commitment to New Zealand being able to take advantage of efficiency gains by consuming services at reducing costs.

TIPPING J:

This is all quite general, Mr Gray. Where, is there anything here that you say has specific legitimate application to construing that definition?

MR GRAY QC:

No, Sir, I don't. I don't, I had never intended to spend a long time on the Inquiry because it is only general and it's the history of the issue, more than the process by which the legislation came to be drafted as an aid to interpretation of the legislation. As Your Honour rightly sees, it's general. We do say those broad themes of technology neutrality and a determination to take advantage of efficiency gains is captured within the legislation, principally within those definitions that we looked at in section 5.

Just briefly on the structure of the legislation. The structural issues that do require some thought, we say, are the precise role that the section 18 purpose plays in the work done by the Commission, because it is a purpose included in Part 2 which deals

with industry regulation. It is drafted in terms that deal with competition within markets and, as is the case with the similar provision in the Commerce Act, doesn't sit immediately within a cost assessment and levying provision for TSO in Part 3. But because, by reason of section 84, subsection (2), it's a mandatory consideration, it must be construed in a way which affects the Commission's work and we say that what section 18 should tell the Commission about the way it does its work is that it is looking to the benefit of end-users, and that's about cost. That it should have a long-term view –

TIPPING J:

But how does the **.....**of end-users come to bear on how much other providers should help Telecom with this burden?

MR GRAY QC:

Well, if the other providers have a cost, they'll recover it from their customers. It reaches the end-user –

TIPPING J:

I see.

MR GRAY QC:

– ultimately, always. But the requirement, Your Honour, that competitors pay Telecom is just a way of spreading the cost among consumers of telecommunication services.

TIPPING J:

Yes, ultimately, certainly.

MR GRAY QC:

Yes.

TIPPING J:

So it's just a question of which consumers?

MR GRAY QC:

Yes, and how much.

TIPPING J:

But, theoretically, the cost should remain constant, it's just a matter of allocation between individual –

MR GRAY QC:

If there are technology changes that yield efficiencies over time, theoretically the cost should be reducing.

TIPPING J:

Oh, yes, I don't mean the costs, I'm not talking about over time, I'm just looking about in one year.

MR GRAY QC:

Yes, yes.

TIPPING J:

Sorry, I didn't put that very clearly.

MR GRAY QC:

It should be constant, it should be constant among all consumers –

TIPPING J:

Yes.

MR GRAY QC:

– by reference to the value of the services they consume. The next structural issue we point to is the distinction between the KSO as a deemed TSO instrument under section 70, under 71 I'm sorry, and the alternative section 70 procedure by which new TSO services are provided. There is only one of those, it's a loop for the hearing impaired. The provider did make specific investments in order to provide the service and the provider was selected after a contestable process of the type identified in section 70.

And then we point to the text and the textual points that we've already made by reference to the definitions within section 5. Now, Your Honours, that might be a convenient time to take the morning adjournment.

McGRATH J:

Just before you do Mr Gray, is there nothing then, in terms of legislative history, that you're going to, that's there for you to take us to, post the Fletcher Report, is there no, are there no committee, select committee reports or other matters that are sort of, of more traditional immediate legislative history value?

MR GRAY QC:

Yes, Your Honour will be aware that we would have looked. There's nothing that focuses on, specifically on whether or not the sunk costs of trenches should be recovered and the way in which the Commission should assess those, the incremental capital. Again, there are general statements about technology neutrality and the need to continue to provide universal service, but nothing that will help Your Honours, we say, with the very specific points.

ELIAS CJ:

Thank you, yes we'll take the adjournment.

COURT ADJOURNS: 11.28 PM

COURT RESUMES: 11.55 AM

ELIAS CJ:

Thank you Mr Gray.

MR GRAY QC:

Thank you, Your Honour. In terms of my outline, I had said we would make some introductory comments, talk about the background to the issue, the text of the legislation and its scheme. I've made the submissions I wish to in respect of those and turn now to the consequences of alternative interpretations.

The interpretation arrived at by the Commission focuses on the definition of net cost. It is that cost is economic cost and not accounting cost, and that an efficient service provider would require a return of investments sufficiently made as a precondition of investing to provide the service, and the Commission and Telecom say that implicit in this is the choice to revalue Telecom's assets employed in providing the service at the commencement of the legislation and the provision of the service, pursuant to the legislation in 2001.

And it said, "The consequence of doing otherwise is to disincentivise others from providing the service, or other TSO services, because providers will not believe they can receive a return of investments they make efficiently for the provision of TSO services". And that, in turn, requires treatment of TSO services provided pursuant to section 70 declared instruments and a section 71 deemed instrument has been, for all intents and purposes, the same. And as the Commission and Arnold J concluded, it means that the word "unavoidable" in the definition of net cost adds nothing and has no additional meaning.

And that interpretation commits the Commission to a return to Telecom of what, in 2001, it assessed to be the cost of providing the assets employed in providing the service over the life of those services, and the life of the assets, and the time for which the assets are employed in providing the service. The trench, of course, lasts for a very long time. Twenty years is the period that is used for the purposes of the modelling.

So the consequence of the Commission and Telecom's interpretation is that for 20 years from 2001, Telecom will receive a return of that investment, theoretical investment, in trenches and copper wires, and that for 20 years from 2001 alternative technologies which might provide TSO services more cheaply will not be modelled or will be modelled in a way which does not result in any part of the core network not being employed to provide the services.

Because the assets are revalued –

ELIAS CJ:

Sorry, does that model exclude the core network cost?

MR GRAY QC:

I'm focussing on the 2003/2004 –

ELIAS CJ:

Yes.

MR GRAY QC:

– the way the model will work is the calls will be returned to the local switch. So they will be modelled to ensure –

ELIAS CJ:

Yes.

MR GRAY QC:

– that the core network to the local switch is employed.

ELIAS CJ:

Which is the effect of saying that the, that the core network, what's been described as the core network, will continue to be the measure?

MR GRAY QC:

Yes.

TIPPING J:

Are you saying that logically this commits the Commission to this sort of method for 20 years?

MR GRAY QC:

Yes.

ELIAS CJ:

Why do you say that?

MR GRAY QC:

Because when the hypothetical investment in trenches hypothetically efficiently was made in 2000, the expectation of the hypothetical investor was that they would last for 20 years and the cost of them would be recovered over a 20-year period.

ELIAS CJ:

What's that derived from, is that in the decision?

MR GRAY QC:

Well it's in the Cornerstone issues paper and the preliminary papers dealing with the tilt.

BLANCHARD J:

So the annuity was set over 20 years?

MR GRAY QC:

Yes.

BLANCHARD J:

And has it been adjusted?

MR GRAY QC:

The value of the trenches increases over time so it increases. The tilt itself is not adjusted, the tilt is established at the commencement and remains as it was at the commencement.

BLANCHARD J:

The value of the trenching increases –

MR GRAY QC:

You revalue –

BLANCHARD J:

– I can understand if you're looking at each year and saying what would it cost to dig that trench again –

MR GRAY QC:

That's what you do.

BLANCHARD J:

– it increases – and is that what they actually do?

MR GRAY QC:

Yes.

TIPPING J:

So it's a fixed term annuity of 20 years but the base position alters upwards each year?

MR GRAY QC:

Yes.

BLANCHARD J:

We never catch up. You'd never get down to zero.

MR GRAY QC:

Well it's repaid over a 20 year period so that in year 19 its current value is assessed but 95 percent of it has already recovered. You use modern equipment assets so that you assess the value of the assets employed on an economic basis, which is what a modern equivalence, but you –

TIPPING J:

Won't there be an overhang in year 19 that you're going to have to catch up at some stage, as my brother says, otherwise you're never going to get there?

MR GRAY QC:

If you have a straight line tilt, then you pay, you return 1/20th of whatever the cost is each year. So if the cost is $20 in the first year, you recover a dollar. If in year 2 it goes to $40, you recover $2. If in year 19 that cost becomes $60, you're paid $3 and you're regarded as having had a complete return off the investment.

TIPPING J:

I see.

MR GRAY QC:

So it's not in year 19 we're going to pay the whole $60 and we're simply going to subtract the dollars that we've already paid.

TIPPING J:

I see.

BLANCHARD J:

So in a way you accelerate the actual payments to take effect of the increase in the present value of the asset?

MR GRAY QC:

Yes. And the way the tilt works is to assume that there is a risk of obsolescence and to repay more earlier.

BLANCHARD J:

Mmm.

MR GRAY QC:

And –

BLANCHARD J:

Tilt's not a very good word.

MR GRAY QC:

Economists have a different way of looking at the world, it's a window –

BLANCHARD J:

I know. Yes well it completely misled me.

MR GRAY QC:

I'm sorry.

BLANCHARD J:

Because we didn't in the papers that I had, have any explanation of what, how a tilt actually works.

MR GRAY QC:

The tilt is designed to recognise the risk of asset stranding. So if you've got a 20 year asset –

BLANCHARD J:

Yes I understood that, but I didn't understand how it worked.

MR GRAY QC:

Sorry. Now we say that the consequences of the interpretation arrived at by the Commission and argued for by Telecom are that more customers may become commercially non-viable because the assets that are at issue and it, as the Commission has said in its own papers, trenching is the biggest part of it, will become more expensive over time, so that the amount received for line rental will for, more and more customers, not cover a return on and a return of the assets together with true incremental direct costs of providing service. There's no incentive on

Telecom to provide service using new technologies because when they do that they demonstrate that they no longer need to use the particular assets that they're seeking to be paid for and more customers will not be commercially non-viable as services are provided using new technology assets. There is a dead weight within the industry which, as we saw before the morning adjournment, is ultimately borne by end-users and because of the very long period for which these assets are valued and employed there's a threat to the extent to which the industry can reinvest and take advantage of new technologies. And we say that's not what the legislation contemplates. That the choice to include the word "unavoidable", that wording combination with "incremental" and "efficient", directs the Commission to look at costs actually incurred, not hypothetically.

ELIAS CJ:

But it's the cost of, it's the cost of an efficient service provider, so why do you say it's actual costs? It must be hypothetical?

MR GRAY QC:

I'm sorry, Your Honour, I –

ELIAS CJ:

Well you say the costs must be actual not hypothetical?

MR GRAY QC:

Yes I'm saying that particularly in reference to a return of capital –

ELIAS CJ:

Yes.

MR GRAY QC:

– employed –

ELIAS CJ:

Yes.

MR GRAY QC:

– has to be capital actually invested for the purpose of –

ELIAS CJ:

I see.

MR GRAY QC:

– providing a service, not hypothetically incurred by revaluing legacy assets, the cost of which largely has already been recovered by depreciation.

ELIAS CJ:

I would have thought rather it was the return on capital on the net cost, is that right?

MR GRAY QC:

Yes, it's where the Commission says cost means economic cost, not accounting cost.

ELIAS CJ:

Yes.

MR GRAY QC:

And the Commission therefore says that the economic costs include the assets employed, which we will treat as new at 2001. And because it's economic cost it includes both the return of and the return on, and that's the point at which we say the consequences of the unreality inherent of that mean that it's not inefficient and it's not consistent with the definition of net cost in the legislation. We say what the legislation means, to the extent that principally operating costs and new investments are involved, then compensation is appropriate or a share of the burden is appropriate.

TIPPING J:

Could I ask you before you move on, Mr Gray, I'm sorry if you were about to – this question of giving effect to the word "unavoidable", an efficient service provider would presumably not incur an avoidable cost. So is not the concept of unavoidable inherent in the concept of efficiency?

MR GRAY QC:

That's Justice Arnold's process of reasoning.

TIPPING J:

Well, I'm asking you what's wrong with that?

MR GRAY QC:

My response is to say, the notional investment in the trench and the wire may have been efficiently made at the time it was made. So that the service provider may have efficiently incurred the capital cost of building that particular part of infrastructure. But if, by the passage of time, the provider can provide the service using other technology available to it – Telecom's got an overlaid mobile network, it has choices about the way in which it provides TSO services to a large number of the commercially non-viable customers.

We say that "unavoidable" means that even though your investment in your copper wire hypothetically was made and hypothetically was efficiently made, nevertheless you can avoid incurring the greater cost of that by providing the service with your own alternative technology, within your network. And that's why we say unavoidable has an additional meaning.

TIPPING J:

The key point being that it is already present within your network –

MR GRAY QC:

Yes.

TIPPING J:

– this alternative method?

MR GRAY QC:

Yes.

TIPPING J:

You don't have to do anything if you like, other than something relatively small presumably, to make it available –

MR GRAY QC:

Yes.

TIPPING J:

– to these uneconomic customers?

MR GRAY QC:

Yes. Now the next point that emerges from that is, well, what about the other customers who are not covered by the mobile network. When would Telecom reasonably be expected to build mobile networks and what's called "cannibalise" its own network? Why would an efficient service provider decide to expand its mobile network to provide service by an alternative cheaper method, when it's already got a pair of copper wires in the ground and incurs no new additional costs, and we all know that boards of directors, when receiving papers that say please invest in these new assets, say to management what is the additional revenue that will be generated by this new investment? If there is no additional revenue, then we don't approve the investment because we're not improving the overall revenue and the answer to that partly is in the nature of telephony itself. It is fast moving, it is moving beyond copper wires, and rational firms will sometimes invest in technologies which enable them to provide service more cheaply, even though it means cannibalising efficient, past efficient investment, both to improve the overall mobile network, because you do create more coverage for all the rest of your customers that are not commercially non-viable. Partly just to keep abreast of new technology, to keep the staff consistent with the switches and the equipment that they are working with. Partly for branding reasons. There are a host of them, but it is wrong to say that a network will never replace outmoded technology only because it's able to provide the same service more cheaply. There are economic evaluations which support that kind of investment. So we say there will be times, if the legislative framework is correct, if the environment created by the Telecommunications Act is correct, there will be incentives to the TSO provider to provide service using new technology, even if that means stranding existing assets. But that is the comp- the other component of the question that Your Honour Justice Tipping was asking, why is it that an efficient provider, having made an investment, why not just sit and say, that's it, we're done for the 20 years or so of our, our trenches and switches and wires.

Although our legislation needs to be construed, and we can't point to legislation in other countries in similar terms, is an aid to construction. The topic of universal service is, of course, addressed in most countries and the ways in which choices are made for the provision of service and the funding of the provision of service is, of course, made in other countries as well. And we've included in our materials, and in

our written submissions, a quick reference to the choices being made in other jurisdictions, if only to show that at the policy level the issue was common and that in other jurisdictions choices are being made to move away from paying to legacy providers the current cost of the legacy assets employed in the provision of service.

In the United Kingdom, for example, universal service is simply paid for by British Telecom, the incumbent, and another provider, and despite requests from those providers for reimbursement, Ofcom, the regulator, has decided that the cost of providing the service is not a great burden and is outweighed by the benefits arising from being the universal service provider, and that can be found in our materials at volume 3 under tab 32 at paragraph 1.17.

In the United States of America, an order was made in 1997 establishing principles for the provision of universal service. Those principles included that forward-looking economic costs be supported, but that embedded costs be rejected, and embedded costs are the kind of costs we've been talking about this morning, the cost of legacy assets already recovered, at least in part, by depreciation. And to the extent that embedded costs differ from forward-looking economic costs, recovery of embedded costs would send the wrong signals for potential entrants and for existing carriers.

And in the United States of America, even under-depreciated plant and equipment shouldn't have its costs returned, because there's no specific evidence that to do that would cause hardship to providers, and that's found in the bundle in volume 4, at tab 34, at paragraphs 224, 227, 228, including footnote 580 and 230.

GAULT J:
I don't see how that comparative material helps us when we have a particular regime that's set out in our statute –

MR GRAY QC:
Oh –

GAULT J:
– they obviously work on a different premise, which our statute doesn't have?

MR GRAY QC:

Your Honour's quite right, of course, and I preface my remarks by saying we need to construe our own statute and to consider our own policies. I had understood the Court wouldn't want to reach a conclusion and construe the statute in a way which was inconsistent with what is happening elsewhere in the world.

GAULT J:

Well, we have to if our statute is different.

MR GRAY QC:

Well, I'm hoping to finish this by saying the statute isn't different, it's the same, but just, and I wasn't planning to take long about it, Your Honour, but just to say this is being addressed elsewhere in the world and the same conclusions are being reached. But I entirely accept your point, Your Honour, that these are not aids to construction of the statute itself, they are at a social policy level.

ELIAS CJ:

Well, I suppose they counter an argument that the result would be absurd?

MR GRAY QC:

Yes, yes. Your Honours I did, we do set out the position in Canada. It's a decision given in November 2000. It noted that historically the subsidy for universal service calculated the difference between –

BLANCHARD J:

Sorry, where are you referring to now?

MR GRAY QC:

The decision, Your Honour, is in the bundle.

BLANCHARD J:

No, no, no, your submissions, where is this in your written submissions?

MR GRAY QC:

They are footnoted, Your Honour, I will have Ms Ferguson find the reference for you and give it to you before I conclude.

BLANCHARD J:

Well, it's really a matter of what we're looking at in your written submissions, what you're speaking to at the moment.

MR GRAY QC:

The material is found partly in the submission dated 11 November 2010 from paragraph 317 to 323 and footnote –

BLANCHARD J:

Sorry, 3?

MR GRAY QC:

17.

BLANCHARD J:

In the submission of 14th of October?

MR GRAY QC:

No they're in the submissions, Sir, of 11 November.

BLANCHARD J:

11 November.

ELIAS CJ:

Unreality of compensating new for old?

MR GRAY QC:

Yes. And Ms Ferguson tells me that Your Honour has caught me, it was a reference that was in the written submissions but was edited out, but the material's left in the bundle, in which case I cannot point to it.

BLANCHARD J:

I see, well, anyway I hadn't realised you'd switched over to the other submissions.

MR GRAY QC:

No, I hadn't Your Honour. I was simply doing as Her Honour Elias CJ succinctly identified, trying to satisfy you that a decision to construe the statute in the way advocated by Vodafone would not be regarded as absurd.

BLANCHARD J:

Yes.

MR GRAY QC:

And I will come to make the ref- the submissions by reference to what's happened in Australia in reply when the written reply submissions are relevant, but essentially what I will then be saying to you is Australia is doing what Vodafone advocates this Court should do, which is turning away from reimbursement of embedded investments and looking towards recovery, when of capital only of actual investments made, or un-depreciated or unrecovered legacy investments. But we'll come to that.

ELIAS CJ:

Where are you going now? I mean, just trying to think where –

MR GRAY QC:

I will finish before lunchtime, Your Honour, I'm simply trying to draw the distinction between –

ELIAS CJ:

Yes.

MR GRAY QC:

– what Vodafone says are the consequences of alternative interpretations of the statute, to conclude by saying, we say that an interpretation which recognises that recovery of embedded or legacy investments is inconsistent with section 5, that it is an error of law to construe section 5 as permitting recovery of those embedded investments, that as is often the case in the field of error of law, there are different ways of looking at the same problem. If it is a factual conclusion that Telecom should recovery its legacy investments under the Net Present Value Equals Zero principle, that that's the kind of error of fact contemplated by this Court in *Bryson v Three Foot Six Ltd* [2005] NZSC 34, [2005] 3 NZLR 721 or by *Edwards v Bairstow* [1956] AC 14 (HL) and itself be an error of law and that we –

TIPPING J:

I'm still focussing on this word unavoidable, Mr Gray, maybe wrongly. What precisely do you say it was there to do beyond the proposition that an efficient supplier, supplier – I know you've answered this before –

MR GRAY QC:

Yes.

TIPPING J:

– but I'm not sure that I fully grasp it, and I apprehend this is a pretty crucial part of the whole debate. I'm sorry, I'm going to trouble you to put it another way or beat it –

MR GRAY QC:

I'm grateful to Your Honour, I don't have a different answer but I can try and express the same answer differently. I start from a proposition that the word must have a meaning. It's there, it is part of the definition, and it's the role of the Courts to give the word a meaning, that it's not for the Courts to say the word has no meaning and can be ignored.

TIPPING J:

Yes, that's a conventional –

MR GRAY QC:

Yes.

TIPPING J:

– prima facie start.

MR GRAY QC:

The second point is, I, an efficient service provider, identifies the conduct of the provider at the time an investment is made. To the extent that the Court is considering a return of investments, assessment of whether the investment was incurred by an efficient service provider will be made when the investment is made.

ELIAS CJ:

Well, why doesn't that tie you to historic cost?

MR GRAY QC:

We say that what unavoidable does is mean that where that provider has alternative means from within its own network of providing the cost, then it can avoid the cost, even though the investment was efficiently made at the time. Now, we accept in –

BLANCHARD J:

Would it have to be from within its own network? If, if Telecom had elected not to put in a mobile network –

MR GRAY QC:

Yes.

BLANCHARD J:

– that somebody else either was doing that or had the ability to do it, wouldn't that have to be a proxy?

MR GRAY QC:

I say, in my submission Your Honour, that the preferable analysis is for the Commission to say, we will re-evaluate whether an efficient service provider would have reinvested in alternative technology. To do otherwise is to argue for a tender, effectively, and we don't do that.

ELIAS CJ:

I'm struggling to understand how your argument fits with the line taken by the President in the Court of Appeal and also by Justice Winkelmann, her determination, because it doesn't seem to me to be the same. I mean, do you support those judgments?

MR GRAY QC:

Yes we do, yes we do.

ELIAS CJ:

I might have another look at them.

MR GRAY QC:

Yes.

TIPPING J:

Are you really saying that it's factual avoidability or unavoidability, rather than economic –

MR GRAY QC:

Yes.

TIPPING J:

– unavoidability?

MR GRAY QC:

Yes.

TIPPING J:

So however economically stupid it might be, if literally the service provider can avoid the cost, they must be taken as doing so, or the calculation must be based on that premise?

MR GRAY QC:

Your Honour's question began with the phrase, "No matter how economically stupid it might be". In my submission, if it becomes economically stupid, the Commissioner's entitled to look at the provider and say, would an efficient service provider still sit on the legacy assets?

TIPPING J:

One of the things that slightly troubles me is a temporal disjunct between the definition and this historical –

MR GRAY QC:

We would say that's because it's both and –

ELIAS CJ:

Well where do you get that from, though, because I don't follow this either? It seems to me that you're arguing for a legacy value to be applied.

MR GRAY QC:

I'm accepting this –

ELIAS CJ:

Except if there is capacity within the network, but I'm not quite sure that the definition is so restrictive, so perhaps you can show us.

MR GRAY QC:

Your Honour, perhaps I can try and walk into it progressively and make it clear. The Commission considered whether it should adopt what are called bottom-up or top-down valuation methods.

ELIAS CJ:

Well it shouldn't, on one view, make any difference which way it starts, as long as it factors in the present position for an efficient provider should it?

MR GRAY QC:

Two differences, partly is how practical and easy to do is the task.

ELIAS CJ:

Well that might be, yes.

MR GRAY QC:

And second, this very question of what do we do about investment decisions that providing firms make, and how do we protect them from the consequences of investment decisions genuinely made and, hypothetically, efficient? And what the Commission spent a considerable amount of time in its early work doing is saying we do need to recognise that these investment decisions have long lives and consequences for a period and we do need to ensure –

ELIAS CJ:

I'm not so interested in the process by which the Commission adopted its views. I'm interested in how the argument you're making to us fits within the –

MR GRAY QC:

Fits with the statutory –

ELIAS CJ:

– statutory language. I mean, you might want to go on and take us to the decision, how it's reasoned later.

MR GRAY QC:

Your Honour, we say that the phrase, "efficient service provider" is an economic phrase and we say that it refers to a provider who has made efficient decisions about investment in the network employed for the purpose of providing the service.

ELIAS CJ:

But that's to look backwards. Why is this provision not forward-looking? So you take a snapshot, a present day snapshot, which is suggested perhaps by an annual reconsideration.

MR GRAY QC:

Yes it is, and to be fair, an annual reconsideration is the thing that would most suit Vodafone because that would yield increasingly lower costs. So, in a sense, by conceding in the way that we have an element of protection for past decision made Vodafone is arguing for less than its very best outcome.

ELIAS CJ:

But what's the concession, then, based on in the statutory language?

MR GRAY QC:

In my submission, net cost means that the provider, having been assessed as having made its initial investment decisions efficiently to the extent that those investments are real investments, not notional re-valued ones, is, if it is an efficient service provider, entitled to expect a return of those investments. We don't challenge the proposition that new investment decisions, made efficiently, should be recovered over time. What we do say is that, however, so that a firm remains incentivised to continue to upgrade its network and doesn't fall into the pitfall of sitting forever on its legacy assets because it has no newer, more efficient ones, because if it were to buy newer, more efficient ones, it would recover less money. The definition of net cost continues to provide an incentive to reinvest and to develop the network by saying that the cost you get is only the one you can't avoid and, if you could avoid it by using your mobile network and if as an efficient service provider you would build one, then the amount that you should receive is the cost of providing the service on that alternative network.

ELIAS CJ:

But that additional bit that you entered, if as an efficient provider you would build one, seems to be a forward-looking position.

MR GRAY QC:

Yes.

ELIAS CJ:

But when you say an efficient provider only has to make provision from its existing, from its existing network, if it has a mobile component, then it seems to me that that's a different matter. You don't need to look at the historic position if you're taking the view that you should have invested in mobile technology as an efficient provider. So I just think there's –

MR GRAY QC:

No I understand, Your Honour.

ELIAS CJ:

– disconnect here.

MR GRAY QC:

Can I connect it by saying this? We accept that there is an uncompensated risk of asset stranding. We accept that a provider might make what seems to be the best decision in year 1 but by year 4 it's no longer the most efficient way, consistent with the legislation, to use the investment that was made in year 1 to provide the service, and a change should be made, and it should be made for the benefit of the community because it's the end-users ultimately who are paying and because the community benefits from the legislation being interpreted in a forward-looking way, and the community employing technology which provides services most efficiently. And the thing I suppose, the position we take, which differs most markedly from our learned friends for Telecom, is that we say there's more risk of asset stranding in the legislation than they will argue is appropriate, we think. And that they say efficient service provider means that once the investment is made in year 1, they're entitled to recovery no matter what happens within the industry in the meantime. They call it a guarantee of return of the investment. And that's where we differ from there because, as I say, we accept that the standard to be applied to, whether or not the investment was appropriate, is efficient service provider, but we also accept that with

the pace of change in this industry, quite quickly, the point may be reached where an alternative method of providing service is cheaper and efficient in the long-term, more efficient in the long-term. So –

TIPPING J:

I wonder whether –

MR GRAY QC:

– in that sense, Your Honour, Justice Elias, we too say a forward-looking interpretation should be adopted.

ELIAS CJ:

Well it seems to hedging your bets a little bit, that you also say that an efficient provider is entitled to a return on historic cost, so it's a matter of degree, of judgment, and if you take that approach it just seems to me that it may well undermine your whole argument?

MR GRAY QC:

Yes it may, I understand that. And we don't say there's –

TIPPING J:

That's what's been worrying me.

ELIAS CJ:

Yes.

TIPPING J:

That's what's been worrying me, Mr Gray. I mean why is your client sort of having six of one and half a dozen of the other, they must – but coming back to a more fundamental point, I wonder whether this is all getting too complicated. What we're talking about here, shorn of the trimmings, is the incremental costs of servicing commercially non-viable customers and those costs are net obviously, but the focus is on those incremental costs and might that not assist with this word "unavoidable"?

MR GRAY QC:

If it's also read together with "incremental".

TIPPING J:

Yes.

MR GRAY QC:

Yes.

TIPPING J:

It's the differential if you like, it's the extra.

MR GRAY QC:

The Commission defines that as, as it's the cost with and without. In other words you add up the cost of the network without the commercially non-viable customers, cost of the network with them and you identify the difference, that's the method by which the Commission assesses the incremental cost.

TIPPING J:

That may well be sound –

MR GRAY QC:

Yes.

TIPPING J:

– but looking at it as a whole, what you're really, what this definition is really looking to, presumably, is Telecom is carrying a burden that it might not otherwise carry. How much do people like your client have to contribute to that burden? Now if the burden can be lessened by a step, which is not, which is, I suppose you then run up against the question of efficient service provider. But if it can be taken, why shouldn't it be taken? The whole idea of this definition seems to me to be to keep the costs down as low as possible, and why – that seems to me to be your best argument. But you're hedging it with this bit that the Chief Justice has been discussing with you.

MR GRAY QC:

Yes.

TIPPING J:

Why are you not going for broke?

MR GRAY QC:

Why are we not going for broke?

TIPPING J:

Yes. There may be a very good reason, and I mean I'm not trying to reformulate your case, it just seems that there is a more straightforward argument available to you.

MR GRAY QC:

We do say that for new investment made in order to provide the service. A decision that there should be a return of that new investment is a reasonable one, and that falls within what we say the Commission should be permitted to consider. We say what's wrong is treating legacy recovered investments as if they were new.

TIPPING J:

But if the cost to Telecom is avoidable?

MR GRAY QC:

We say it's not incremental. We say it's not an additional cost incurred by Telecom in 2001 in providing the service.

TIPPING J:

But if, can I come back to it? If the costs to Telecom is avoidable, i.e. they can literally do it by the mobile, why are you not arguing that they should?

MR GRAY QC:

We are. Forgive me, and that really I suppose is the link back to Your Honour Justice Elias' question, "Are we consistent with what Justices William Young and Winkelmann have said?" We do say that Telecom, if it can provide by mobile technology, should be providing by mobile technology. We say that –

TIPPING J:

Irrespective of sunk costs and stranded assets and all this other hooha.

MR GRAY QC:

Absolutely. The fault would be mine.

ELIAS CJ:

I would've thought that was scorched earth. I'm not saying that that's wrong, but I would've thought that that is what it is, it's properly characterised as. Because it means that you look in any year where you're doing the assessment and you say, "What could an efficient provider provide this, at what cost could it provide it?"

MR GRAY QC:

Your Honour, the problem I've had with that is a definitional one, what is the Telecom network? The Telecom network is the whole of its network.

ELIAS CJ:

Yes.

MR GRAY QC:

And we're not scorching any of it, we're simply choosing to employ a different part.

ELIAS CJ:

Yes, yes, I understand that's fair enough, yes.

TIPPING J:

So that is your real argument, that they could do it, leaving aside all these sunk costs, et cetera.

MR GRAY QC:

Yes.

TIPPING J:

And they should, at least, be taken to be doing it for the purposes of this calculation.

MR GRAY QC:

Yes. And they should be encouraged for the rest of it to do it as cheaply as they can. Which is the harder part of the argument, I concede.

TIPPING J:

Well I'm not sure what you mean by "for the rest of it".

MR GRAY QC:

Where there isn't existing network coverage.

TIPPING J:

Oh, well that – we don't have to worry about that, do we? Because there is, as I understood you –

MR GRAY QC:

Not for all of the commercially non-viable customers –

TIPPING J:

Oh, I see.

MR GRAY QC:

– only for a number of them, it's not the whole.

TIPPING J:

So we've got two issues. One, should they do it, be deemed to do it for the – where they can, and then what do they do where they can't?

MR GRAY QC:

Yes.

TIPPING J:

Well, why can't they have it the Commission's way where they can't?

MR GRAY QC:

The reason we don't want them to have the Commission's way is the one that Your Honour articulated in a question a little while ago, which is, "Well do they then not build the cellular network, because to do so is to cannibalise the copper wire network, and do we incentivise them simply to sit on the copper wire technology because they make more money by doing that?" And we say that's not the way the statute could be construed, we say it's –

TIPPING J:

Maybe the answer is that the Commission was right in relation to those ones, but with a caution that it won't last very long, but they were wrong for the ones where it could be done.

MR GRAY QC:

Well if the Commission had said, "We've got an overlaid network, you can use that", perhaps. But remember that in 2003/2004, the first year, what the Commission did with mobile technology, was simply use it to provide point-to-point radio services, so it required, it ignored entirely the overlaid network, it pretended it didn't exist. If there were cell sites in place within the area already, it ignored them. It then modelled the building of new cell sites and a new receiver on the spot where the switch was, and it used mobile technology to simply connect by radio where previously there'd been a wire or wireless local loop or multi access radio. And, what's more, with cellular networks there are a limited number of radio channels available from each transmitter to provide service, and certainty that your call will be made and held for the duration of the call is provided by backup coverage by surrounding transmitters. And in that way it's a honeycomb-type network. What the Commission did was not only ignore cell sites that provided coverage within the geographic area within which the non-viable customers were located, it also ignored the neighbouring cell sites which could have provided backup coverage and so, in order to provide the required grade of service, in some cases it modelled duplicate cell sites being built, so as to provide the backup that would be required for the graded services. And we say that is what we said in respect of the 2003/2004 decision was wrong. It was an overly expensive, inappropriate way of employing mobile technology, especially where there's an existing overlaid network.

TIPPING J:

Which is a bit odd, because an efficient service provider would never do that.

MR GRAY QC:

Correct. An efficient service provider would look at the, its existing network. It might ask, in order to meet TSO quality of service requirements do we need to build an additional transmitter to supplement what's there, and that might be incremental capital. And to the extent that that transmitter is truly incremental to the network and only for the purpose of the TSO, then we get to the difficult debate that we've just been having. But our complaint about the 2003/2004 determination is much more fundamental. It is that having decided that mobile technology was appropriate for the

service, you were wrong to ignore the overlaid network and you were wrong to employ technology, mobile technology, as a proxy for other point-to-point radio technologies, and that's too expensive and unnecessary, it duplicates resources unnecessarily. Now of course later they came to ignore it completely, mobile technology completely, because of their view that they were committed to returning to Telecom this theoretical cost of investing in the trenches.

So we do support the judgments of Justice William Young and of Justice Glazebrook, we do say that the overlaid network should be considered, it is part of Telecom's network as that is defined in the legislation. Telecom can avoid cost by providing service using its overlaid assets and Telecom can limit incremental capital, new capital it may have to spend, by supplementing, in many cases, its mobile network if that is necessary. And we say that the legislation mandates that, it's open textured in the sense that it's technology neutral, it is forward-looking and it incentivises investment in New Zealand in technologies which are efficient, which enable more connectivity and better services.

Now I don't know if I've dealt with all of Your Honours' questions.

ELIAS CJ:

Well, I don't think I have any more at the moment.

MR GRAY QC:

I think it's right and it's the role of counsel to accept whole responsibility for any highways and byways that we may have gone in, but we say that the case actually is reasonably straightforward, despite the great engineering complexity of the networks, we say they don't drive determination of the issue. We say it's a matter of looking at the definition of net cost and saying when there are, when there is a network composed of multiple technologies which can be employed to provide service, does this legislation require the cheapest one to be used, and we say yes. We agree with the proposition, though, articulated by His Honour Justice Tipping, that the definition of net cost drives towards lowest cost. Because the cost of this is spread among the community, among end-users, what the legislation seeks to do is not to create windfall profits or to overcompensate or a risk or bias towards overcompensation but to have the end-users paying as little as is necessary to provide the service. And we say that when new technologies become available they should reasonably be employed and modelled. And when challenges are made that that approach is a

challenge to scorched node and in fact is scorched earth, as I said in answer to a question from Her Honour Justice Elias, in part the question becomes definitional and trespasses into the difference in technology between wire-based networks and radio-based networks. Because of the different architecture of the radio based networks, delivering and handing over calls from one transmitter to another controlled by a central nervous system, which is constantly monitoring how a call is placed – when a call is made to a cellphone – a cellphone has a control channel, a signalling channel which is not used for voice communication but which is communicating back to the networks saying, this is where I am, this is where I am, I'm turned on, I'm available to receive a call. When a call is made, sometimes you can see a phone light up before the phone rings. The network is saying to the telephone, a call is coming, be ready to receive it on channel 32. The telephone –

ELIAS CJ:

Sorry, what's this all about?

MR GRAY QC:

About the different architecture of a cellular, of a mobile network –

ELIAS CJ:

Yes.

MR GRAY QC:

– from wire –

BLANCHARD J:

I think we understand that point.

MR GRAY QC:

Okay, then I don't need to. But the rational place to connect services being provided using mobile technology is not necessarily the location – necessarily the location of the local switch –

ELIAS CJ:

No.

MR GRAY QC:

– in the wire network.

ELIAS CJ:

I understand that.

MR GRAY QC:

And it's inappropriate and inefficient to model it as if that's where it's being delivered.

ELIAS CJ:

Yes.

GAULT J:

Mr Gray, I'm all over the place here but the point I'm struggling with is this introduction of new technology where it does not in fact supersede the existing or previous technology because that still is being used, and it seems to me we've got a sort of transitional period when the wire network is still operating, is still serving some, at least, telephone customers, maybe not as many as before and so it's very hard to talk about this as being superseded by a net – by a mobile technology because it is in part, but the investment decisions don't have one superseding the other completely, the capital is still being employed and this – you have – I need some help with that.

ELIAS CJ:

It's a – it's supplemented really by the new technology.

MR GRAY QC:

The starting point is, we're not actually concerned with how the calls are delivered, we're concerned about what price competitors pay for the provision of service and the policy choice in the legislation is that the price that's being paid is the price that represents the unavoidable incremental net cost to an efficient service provider. And so the assessment we're making is not so much what's actually being used or how is Telecom managing its network, it's what price should the community pay. And that price is the price that's reached by the definition of the Act, which is the definition of net cost, and it does contemplate that new technology will be used over time even if the old technology remains in place and is in fact used. The new technology will be used for the purpose of determining price.

GAULT J:

I mean it's not as simple as that, because it is determining price only because a – the other technology still is there. I need to think about it but I just – sound my difficulties.

MR GRAY QC:

We are here because the topic's not entirely straightforward so –

ELIAS CJ:

But you don't need to say what the outcome would be. You just need to say that the Commission's approach was wrong in application of the legislation –

MR GRAY QC:

Yes.

ELIAS CJ:

– at that stage there may be quite a complicated assessment for the Commission to undertake, but we don't need to dot all the Is and cross all the Ts – is that the –

MR GRAY QC:

We're not asking Your Honours to fix it, we're asking Your Honours only to say that it's wrong and we ask that the Commission be invited to do it again with the guidance that will be in your decision.

TIPPING J:

Mr Gray, I made a note which I hope was close to the essence of your argument and just bear with me if I put it to you and you tell me whether this is so. That you said, I thought you said that when multiple technology is available the legislation, for the purpose that we're concerned with, contemplates that use should be made of the cheapest?

MR GRAY QC:

Yes.

TIPPING J:

Is that –

MR GRAY QC:

Yes.

ELIAS CJ:

Or the cheapest combination presumably as well?

MR GRAY QC:

Yes. Within the network, yes.

TIPPING J:

Within the network?

MR GRAY QC:

Yes.

TIPPING J:

Within Telecom's network because it's – well within the network because of course the definition looks at an objectively, to put – one has to, as it were, have the objective service, efficient service provider has to be provided with some attributes?

MR GRAY QC:

Yes, yes.

TIPPING J:

That's all right, I just wanted to make sure I had that.

MR GRAY QC:

I'm aware, Your Honour, I haven't answered Justice Gault's question but I wonder if I may do so more succinctly after the lunch adjournment?

ELIAS CJ:

Yes of course, we'll take the lunch adjournment now.

COURT ADJOURNS: 12.59 PM

COURT RESUMES: 2.14 PM

MR GRAY QC:

Thank you Your Honours. Before the luncheon adjournment I had left unanswered a question from Justice Gault which was well, what does happen with existing investments, as I understood at least the beginning of His Honour's question, and our response to that question is this. First, on the facts of this case, remember that TSO services are provided to consumers as they existed at the inception of the scheme. So it didn't require extension of services to any new end-users. It did require Telecom to build, only to continue to serve those who were being served at the time.

Second, as we say, there was no new investment. There was no incremental investment and so there's nothing to return and there's no incremental capital to be returned or for there to be a return. The challenge is the hypothetical case where there is a new investment, and our answer to that is to say that funds do need to be invested and they need to be invested efficiently, and the definition of net cost requires the investment decision to be an efficient one. And at that time an assessment is made of the tilted annuity required to protect the investment. The assessment's made at the beginning. As it would be in any business, you look forward and you say, for how long are we likely to be able to generate revenue from this investment and we price it so that we obtain a return of it and a return on it for the anticipated life of the investment. And if the risks of stranding are higher than normal, then the tilt reflects that. If, subsequently, the asset is stranded more quickly, there's an unrecovered loss. If, subsequently, the asset lasts for longer than anticipated, there's a gain. But that loss or gain is a business loss or gain, arising from business risks made at the time.

So when I submitted earlier that there was a different time applying to assessment of efficient service provider and unnecessary, I'm sorry, the word that's unavoidable, and Her Honour Justice Elias questioned me on that, with respect Your Honour was correct, it is not sustainable for there to be different times. They must both occur annually and the protection that we were looking for arises from the tilt to the annuity which is established at the time the investment is made.

So the answer to Your Honour Justice Gault, in the hypothetical case of new investments having been made, is when the investment is made, an annuity established with a tilt that reflects the judgement at the time of the expected life of the asset, and that judgment will either prove over time to be correct, optimistic or pessimistic, and there will be a gain or a loss as a result, but that's like any business

decision. When any business invests in a piece of new plant, it does so expecting it to generate revenue for a time and over time that judgment will either be proven to be correct, optimistic or pessimistic.

Now, in this case, if the hypothetical that applied at 2001 and for some reason the existing customers who required TSO service could not be served by copper wire, then Vodafone would say, we wouldn't built a new one, it wouldn't be efficient to build a 20-year asset in the expectation that mobile technology would be able to supersede it within a short space of time. Instead, something would be done to provide service in the short-term. That something might have been more expensive in the short-term, but have left open the possibility of adoption of cheaper and more efficient technologies later when they became available, and we say that's what an efficient service provider would have done at the time.

So I have changed my submission in relation to the time at which efficient service provider is established and for which it operates. I accept that the evaluation is made each year. The protection that Vodafone is conceding, and about which I was quizzed before Christmas, before lunch –

TIPPING J:
It seems like that, Mr Gray.

MR GRAY QC:
The never-ending submission Sir. Is protected by the annuity and the tilt to the annuity, which is adopted when the investment is made.

BLANCHARD J:
And that tilt doesn't get reviewed?

MR GRAY QC:
No, it doesn't. Like any business investment, it's your best judgment at the time the investment is made.

ELIAS CJ:
And wouldn't there, on that, be an industry standard that the Commission, that would be latched onto?

MR GRAY QC:

Yes, these are not judgments made in a vacuum, there are – telephony companies gather and there are predictions about where technology will go and when new technologies will be available, and the gains that might be expected from them. And of course there is a lead time for the design and manufacture of technological equipment of this nature. And so we say that the definition of net cost does contemplate both efficient decisions at the time the decision is made and the establishment of protections for the consequences of that decision, but also annual review of what is efficient and whether costs truly are both incremental and unavoidable.

Now I hope, Justice Gault, that addresses the question as I understood it, I may not have –

GAULT J:

I don't think it does quite, but I'd like to reflect upon it, rather than pursue this now.

ELIAS CJ:

This might be an over-complication, but just relating the submission to the wording of section 84 and the net cost, does that mean that the provision of a reasonable return, no that can't be right. I was wondering whether you were making the submission that the provision of a reasonable return on the incremental capital employed was employed in fact, or whether that was – I had read it as simply referring to the unavoidable net incremental costs to an efficient server. But it maybe that there is something a little bit more in it.

MR GRAY QC:

One part of the answer, Your Honour, is we accept it is within the expertise of the Commission to decide whether accounting cost or economic cost best reflect costs, and in order – and we accept that the Commission can model a network and it doesn't actually have to ask Telecom to produce a whole series of invoices and costs in that type, of that type. So we do accept that incremental capital can be modelled or assessed rather than calculated, but I don't know if that's the point that Your Honour was inquiring about.

ELIAS CJ:

I suppose I was wondering whether section 84(1)(b) is a reference to the incremental capital actually employed.

MR GRAY QC:

Yes.

ELIAS CJ:

And how that relates to the definition of net cost.

MR GRAY QC:

Well incremental appears in both doesn't it?

ELIAS CJ:

Yes.

MR GRAY QC:

We interpret 84(1)(b) really as clarifying that net cost includes incremental capital as well as incremental direct cost. It's possible to look at the definition of net cost and to have an argument about whether what's intended is only direct costs, or also a return on capital. And that's not clear from the definition of net cost itself, and whether or not a return on incremental capital also is recoverable is clarified, we say, by section 84(1)(b). But we note that the word incremental is common both to the definition and to section 84(1)(b), and it does mean the bit –

ELIAS CJ:

The additional.

MR GRAY QC:

Yes.

ELIAS CJ:

Yes, thank you.

MR GRAY QC:

And so, Your Honours, we say that Justice William Young and Justice Winkelmann were correct, that it was an error of law to do what the Commission did. We say that Justice Glazebrook found it was an error of law but was prepared to allow the error to

continue for a time, albeit a short one, because the process by which what we say the, was an error was made, was a reasonable one and we say that's an appropriate response if there was an error of law. That's an end to the matter. And we say Justice Arnold really reached a conclusion to the same effect. He conducted a reasonableness review of the process and the substance of the decision. We interpret his judgment as concluding that the decision was one made within the expertise and power conferred on the Commission, and for that reason it would be inappropriate to interfere with it, even though he could see in the passage that I referred Your Honours to in opening that there was a problem that would have to be addressed over time. And again we say that that was not the correct approach to take to the question. That the question involved the construction of the statute and whatever is that construction must follow.

We do say that the appropriate remedy is for the matter to be remitted back to the Commission and we accept that if the concerns that Vodafone raises are remitted back to the Commission the Commission should be able to consider all aspects of the levy and we do not, as Telecom seeks to do, in its asset beta judgment, ask to have remitted back only a discrete factor, leaving the rest undisturbed. We say that the valuations made by the Commissioner are interrelated and affected by other evaluations and it's not sensibly possible to identify discrete judgments and seek to have them reconsidered.

And if Your Honours have no further questions, those are my submissions.

ELIAS CJ:

Thank you Mr Gray. Now, what order are we taking you in? You Mr Hodder, is it?

MR HODDER:

The arrangement is it about falls to me, Ma'am. As is the way with these things, there's a short route to where I wish the Court to find itself concluding, and a long route, unfortunately I'm going to have to take the long route, because I don't imagine you're going to accept the short route, at least not –

ELIAS CJ:

Why don't you try us on the short route?

MR HODDER:

Justice McGechan was right. This is not a question of law that we're concerned with in terms of Vodafone's appeal.

ELIAS CJ:

Right.

MR HODDER:

And his discussion is in volume 1 of the case on appeal, at tab 4 we find the judgment, and the particular paragraph we say –

TIPPING J:

How do we deal with this in the light of the fact that the Court of Appeal said they would give leave to appeal even if that was so.

MR HODDER:

Well there's only a right to appeal on the question of law.

TIPPING J:

What was all that other, what was the reference –

MR HODDER:

That was a question about whether you could get to the Court of Appeal under the provisions applying to appeal rights.

ELIAS CJ:

Of the Commerce Act, that's right, yes.

MR HODDER:

I think the Commerce Act provisions.

ELIAS CJ:

That's right, yes.

MR HODDER:

But there's no doubt the only question of –

ELIAS CJ:

There still had to be a question of law?

TIPPING J:

There still has to be a question of law.

MR HODDER:

It does.

TIPPING J:

To get to the High Court, yes.

MR HODDER:

Sorry, I just want to read the –

ELIAS CJ:

But beyond –

TIPPING J:

I'm just looking for a quick answer to his quick submission.

ELIAS CJ:

No, but I was going to encourage you, Mr Hodder, not to be too quick on this and by all means take us to the conclusion, but you might also want to take us to the statute to explain why you think that's right.

MR HODDER:

I'm afraid that I'm going to spend a bit of time on the statute and on the determination that's under appeal, and on the judgment of the Court of Appeal that's under appeal. But what Justice McGechan said was, "After making the basic and unchallenged decision to operate on the basis of scorched node", which is an accurate reflection of the argument, "it established what an efficient service provider would do", that is, the Commission established what an efficient service provider would do, "that is a factual evaluation and the conclusion reached was open."

Now, in our submission, well I can elaborate that, and I will elaborate in some detail, is the short point that what Vodafone seeks to do is to address a number of concerns that effectively arise out of inherently intricate economic analysis as some definitive

question of law. Now what I – that's the short submission. The longer submission involves a pathway that has its various stages.

Firstly I want to raise the question of what are the right questions to ask, then I want to go to the Act and address what other relevant considerations had to be taken into account for the purpose of the Commission's work. Then I want to address the way in which the scorched node decision was made, because the scorched node decision is the one that goes to the heart of most of the matters that the Court was addressing to my learned friend Mr Gray. And then I move onto the question of what is a question of law and in that, as the Court may recall from our written submissions, I'm wishing the Court to accept a line of authority that is exemplified by the House of Lords' decision in the *R v Monopolies & Mergers Commission*, *ex parte South Yorkshire Transport Ltd* [1993] 1 WLR 23 (HL), which appears not to have been addressed at the appellate level in this jurisdiction, although I think it's a bit like speaking prose, it's what the Courts have been applying anyway in practice and a range of decisions that have been dealt with.

And in my submission I will suggest that this Court's decision in *Unison Networks Ltd v Commerce Commission* [2007] NZSC 74, [2008] 1 NZLR 42, which both parties make reference to, is an example of the same sort of point. That's effectively the way which I deal with most of Vodafone's appeal, but I have three appeals to address rather than one so I'll take rather longer. In relation to the second matter which is effectively the question of modelling and NPV=0, I'll take some time in relation to that, but the basic proposition is that the Commission got that right, and the last proposition is our appeal in relation to asset beta. And the reason I perhaps should make this clear at this stage, the proposition that I draw from *South Yorkshire* and a line of other cases is that in relation to these matters there is a margin of appreciation where the language is open to different judgments for the statutory decision-maker, but there are limits and the limits include unjustifiable and inconsistencies and it's on that head that I say that Telecom's entitled to say to you firstly, Vodafone's appeal falls foul of the question of law proposition but Telecom's does not when it comes to its appeal on the asset beta, because we say there's an inexplicable inconsistency there which takes it outside the legitimate margin of appreciation that is otherwise recognised in the *South Yorkshire* line of authority.

TIPPING J:

Are you saying there's a margin of appreciation in relation to statutory interpretation as opposed to application?

MR HODDER SC:

Yes. Though I'm not – we don't need to get into that one, I'm not advocating a strict, you know the State Supreme Court *Chevron* approach, I'm simply offering what the –

BLANCHARD J:

You mean if the statute read, can be read two ways, each of them being reasonable, you can't complain that it's been read the wrong way?

MR HODDER SC:

Well that's – the proposition is whether you can come to a wrong way and the line of authority that I rely on says in some matters you can't come to that view, where the language is general, the Courts cannot say there is one right answer as to, for example, what net costs means. It simply isn't amenable to that kind of definitive decision. So that's the proposition, it's not in the written submissions and I'll come to it, if I may, after I've dealt with the Act and with the determination that's under appeal.

So the first question is, what are the questions? And I've partly addressed that, but with respect the first question that really arises, is the reason that we are here, is under section 92 of the Act. Now section 92 repeats much of what you find at the earlier stage and other provisions but effectively it says that in the final determination under section 90 the Commission must include a statement of the net cost of complying with the TSO instrument during the relevant financial year. That is the ultimate question. But it then has a whole series of other questions and the real question is, how does the Commission calculate net cost as used in section 92 in the context of Part 3 of the Telecommunications Act?

That takes us to the next question, which is what are the relevant considerations under Part 3, and I'll come back to that. And then a series of further questions follow. Is a modelling methodology necessary or legitimate? I understood my friend Mr Gray to concede that just a few moments ago. Is the choice of such a methodology a matter of law? In our submission the answer is no. Are there limits on the choice of such a methodology or the application of methodology and that's where it comes closer to the appeal on the asset beta issue. And so in relation to that, one goes on

to say, is the NPV=0 principle one which a body such as the Commission is entitled to use as an underpinning for its approach? We would say, of course, yes. Are there tradeoffs between NPV=0, or in other words dynamic efficiency, and the modelling of new technologies? The answer is yes in our submission. If there are, is the right trade-off a question of law? In our submission it is not. And then finally the question is, does the Commission's 2004-5 asset beta reduction fall outside the margin of appreciation that I referred to earlier? Now I'll be addressing, not discretely as I have just spelt there, but I will be addressing broadly all those questions as I move through.

So could I then turn to the Act, which is conveniently found in volume 1 of the case on appeal. I'm tempted to use a word that Fordham uses in his handbook of *Judicial Review*, which is the word "relevancies". First of all I was bit unattracted to it, but it's quite a convenient way of saying relevant and irrelevant considerations in few syllables. So in my submission when we look at Part 3 of the Act, and that's the critical part of the Act, and including the cross-references as we'll see to section 18, there are a series of relevancies, if that word is acceptable, that the Commission has to take into account. When we reviewed all those, the submission will be that having regard to all of those considerations there is no right question of law answer in relation to what net cost means.

So let's start with section 70, if that's convenient. The beginning of subpart 1. The purpose is clearly a social policy purpose, is designed to ensure that those to whom it might not be economically efficient to provide particular services are provided with those services, and the mechanism that's set up under Part 3 is a way of the Government not paying direct subsidies for telephone services but requiring it to be picked up by the industry and passed on. So the fact that it's a social policy obligation is a relevant consideration, we say, and indeed the Commission does take it into account in its later determinations expressly. Then subsection 3 of section 70, we note that in relation to TSO instruments there must be an agreement, 70 subsection (3)(a) and the same point is picked up in (4)(a), recording a contract or arrangement. What are contemplated are a series of voluntary arrangements between the TSP, the provider of these services effectively, and the State, for whom the Commission acts as a kind of proxy, on the other side of the bargain. And we say when we come then to the next section, section 71, when the Telecom arrangements are treated as a deemed TSO instruments, all the same considerations must apply that apply to section 70. And as the Court knows from our

written submissions, if you are looking to have a regime that depends on voluntary arrangements, then they cannot be punitive otherwise it simply doesn't work. And what most of the network modelling issues go to is avoiding this situation where providers will regard themselves as having been punished for getting themselves in the position of providing these services.

I should say at this point, with respect to my learned friend, this case is not really about Telecom, I mean obviously there's a real politic that it's about Telecom, but this case is about the party providing TSO services, no matter who it is, and talking about Telecom and its own particular attributes doesn't, in our respectful submission, clarify the issues that have to be addressed on this appeal.

BLANCHARD J:

And anyway I think you're arguing implicitly that Telecom was once a volunteer and this is a mere continuation.

MR HODDER SC:

I don't think I need to, otherwise we're getting into some history which I don't have evidence about here. It should be treated as a volunteer, that's all I'm saying.

ELIAS CJ:

This is an imposed obligation, though, on Telecom?

MR HODDER:

It may be, that –

ELIAS CJ:

Which is not to detract from the point that you are making –

MR HODDER:

There can't, yes, my point is simply there cannot be a difference between the way in which the Court approaches, sorry –

ELIAS CJ:

No.

MR HODDER:

– the Commission approaches –

ELIAS CJ:

The method –

MR HODDER:

– the net cost under 71 or 70.

ELIAS CJ:

Yes, yes.

MR HODDER:

It has to be the same result.

ELIAS CJ:

Yes.

MR HODDER:

If it has to satisfy the expectations under section 70 of the volunteer. There is also a consideration which we don't need to be concerned with here under section 74, and it crops up later on in relation to compliance. Whatever regime is there has to be one that you can assess compliance against. If we move on to section 76, at the end of it we see again in relation to variations or changes that again requires agreement, emphasising the volunteer point I've been making, that emerges in section 76(2)(a), for example, and (2)(b).

Section 78 is a relevancy in our submission. Section 78 says that Part 2 of the Commerce Act, and most obviously section 27 about arrangements and understandings, doesn't apply, but again it's appropriate, we would say, for the Commission to keep in mind the fact that whatever arrangement there is under the TSO is one which is not subject to standard competition law. That's a factor that it's entitled to take into account.

Section 80 comes back to the topic of compliance.

Section 81 and section 83 emphasise the information that the Commissioner's entitled to require. So 81 says, "The TSP must provide to the Commission any prescribed information to enable it to convert to draft determination, particularly in relation to revenue," and 83 says that the report, the audited report of the TSP's own calculation of net cost, "Must be in accordance with prescribed requirements relating to those calculations". And likewise, in section 84(3), "The TSP must comply with any requirements relating to any of the matters that are relevant to the application." And it may be worth taking a moment just to read to you, if I may, why it's not about Telecom.

In volume 5 at tab 50 there is an example of the letter that the Commission sends to Telecom, or sent to Telecom, this is tab 50, page 1976, to get the information that's required under section 83. And so the letter is written on behalf of the telecommun- or by the telecommunications committed to Telecom and says, "We are setting out the requirements of the Commission under section 83(b)(2)." Second paragraph, "To calculate the net TSO cost, the Commission requires that Telecom use the versions of the Commission's HCPM and CostProNZ models that were used for the Commission's 2002/3 determination, along with the input data, including the rate the Commission used for the draft determination."

Now it's not a major point, but the point is, Telecom's not giving up its information about what it thinks the net cost is, it's being told what to give, and it follows from the terms of section 83. Again, my point is that this is not about Telecom, this is about the hypoth- hypothetical ESP that the Commission is concerned with.

The next relevant consideration, again not worth any weight for the purposes of the present appeal, at section 85 about revenue basis. Section 86 is relevant. It's a point that Arnold J made in the Court below. There is quite a tight timeframe here. In effect it adds up to about 180 days if all things go according to plan, which is not, as the point Arnold J was making, not time to estimate the costs in relation to not only Telecom's network, subject to the requirements of it, but also of its mobile network and indeed for that matter, Vodafone's mobile network.

In section 88 we see that there is some regard had to the actual TSP, as opposed to the hypothetical ESP, but only in limited circumstances, so section 88(a)(1)(b) when it's talking about information that might unreasonably prejudice the commercial

position, is a point that focuses back to the actual TSP, as opposed to the hypothetical TSP.

ELIAS CJ:

Sorry –

MR HODDER:

That's section 88, subparagraph (a), subparagraph (1), subparagraph (b).

ELIAS CJ:

Oh, yes.

TIPPING J:

Would the whole of that subparagraph (1) refer to the actual?

MR HODDER:

Sorry to the – ?

TIPPING J:

Actual, rather than the hypothetical? The net cost to the TSP during the TSP's financial year?

MR HODDER:

I'm not sure that it would, Sir. In the sense that if the Commissioner is actually asking for net cost on the basis I've just indicated for under section 83, then you're not going to get the actual cost, you're going to get a cost which is one deriving from the Commission's requirements. The net cost is net cost in accordance with the Commission's methodology.

ELIAS CJ:

In accordance with the statute.

MR HODDER:

In accordance with the statute, and the question is, does the statute allow for economic cost, as opposed to historic costs, in which case you're into a hypothetical exercise.

TIPPING J:

I don't see how you can carve out paragraph B from the rest?

MR HODDER:

Well, there can't be an unreasonable prejudice about information –

BLANCHARD J:

About the hypothetical commercial position?

MR HODDER:

I don't think so, Sir, I, actually, on reflection –

BLANCHARD J:

But does much turn on this?

MR HODDER:

It doesn't, but I think on reflection it may be that if one brings the "and" as conjunctive, then I defer to Tipping J's analysis. I am happy to accept that.

TIPPING J:

Well, as long as it's not important, I don't really care, Mr Hodder.

MR HODDER:

It isn't, but I'm happy to treat "and" as conjunctive.

ELIAS CJ:

Well, except there's the same, perhaps disjunctive approach in 84, in terms of net cost and then reasonable return. So –

MR HODDER:

Well, we take issue with that proposition. We don't say there is a disjunct in 84.

ELIAS CJ:

No, well, perhaps not a disjunct, but what I'm saying is there are two things being referred to with the reasonable return on incremental capital, not repeating the net cost definition. So that it is possible that it is a reasonable return on actual employed capital I suppose. I mean –

MR HODDER:

Well.

ELIAS CJ:

– I don't entirely follow it.

MR HODDER:

I think it becomes, I hope it becomes a little clearer if I can take the Court to the reasoning the Commission uses in the determination under challenge, but inevitably in this world of cost allocation, there is a need to go into hypotheticals. That fact is it is very difficult to assess costs and particularly forward-looking costs. As they say, these sort of predictions about the future are quite difficult, so that aspect of it, and in our submission 84 is solely concerned with the hypothetical ESP. The point I was making in relation to 88 is simply that it, in a couple of places it touches on the actual TSP and that's one of them.

Carry on –

ELIAS CJ:

Sorry, I just want to be sure I've got that right. You say 84 is, is wholly concerned with the hypothetical?

MR HODDER:

Yes. It's a hypothetical net cost.

ELIAS CJ:

ESP, but 88 is not?

MR HODDER:

88(a) is not. What – remember there are two parts to the equation that the Commission's engaged on –

ELIAS CJ:

Yes.

MR HODDER:

– the first is that we assess the net cost, the second is to allocate it.

ELIAS CJ:

Yes.

MR HODDER:

To allocate it, it does require actual numbers so it can assess what the revenue ratios are between the various providers.

ELIAS CJ:

Yes.

MR HODDER:

So to that extent we're talking about the real world.

ELIAS CJ:

Yes.

MR HODDER:

But in terms of assessing what the net cost is, our submission is that it's an economic concept and it's not one that is focussed on the real world, except to the extent that the economic model can encompass the real world. But the reason for an economic model is that it's not easy to encompass the real world.

ELIAS CJ:

No, it sounds very Platonesque.

MR HODDER:

I'm not sure whether to say thank you or not.

TIPPING J:

I wouldn't if I were you.

MR HODDER:

I'll take Tipping J's advice, thank you. Carry on, if I may, to section 89 and section 90, simply indicate that relevant considerations include the submissions made by interested parties at the conference. And then I am going to turn over to section 99.

ELIAS CJ:

Are you coming back to 92?

MR HODDER:

I think we're going to spend all our time on 92.

ELIAS CJ:

Yes, all right, thank you.

MR HODDER:

There's nothing I can say about it in this sweep through, because these are all considerations, in my submission, that go to what 92 is asking the Commission to do. So temporarily bypassing 92, we go on to 99, it's the same point I was making before. This does come back to, as it were, an aspect of real-world competition. What a liable person cannot do is say, when it sends an account out to a consumer, "Our charges (very reasonable $5), plus outrageous charges paid to TSO provider $50." What 99 is doing is saying you can't do that. It's saying that you have to have a level playing field, that there should be no competitive advantage out of the fact of the scheme. And that reinforces the social bargain aspect of it.

TIPPING J:

But you could separate it out, but not name anybody.

MR HODDER:

Yes.

TIPPING J:

Is that the way it works?

MR HODDER:

Yes, it's a way that you can avoid pillorying the TSP in your invoices. So it's meant to try and minimise the damage that's done under the scheme to the TSP, sort of by limiting the scope for competitors to beat it up for the fact that it's increasing the charges that the other viable persons might otherwise charge. And then for completeness I just note section 100, subsection (2), that we are here talking about appeals on questions of law only. So that, we say is – I'm sorry, in the course of that I had dealt only briefly with the requirement under section 84 to consider section 18.

And if we go back to section 18, it is true that section 18 appears in Part 2, which is dealing with, in effect, the interrelationship between telecommunications companies such as those who require access to the PSTN to provide the services they wish to offer. But it's deliberately reincorporated back into Part 3 by virtue of section 84, as we've seen, and it can't be read out, which means that one is looking at long-term benefits, i.e. not one-year benefits. One is looking at efficiencies.

All of those factors that I've been attempting to draw attention to go to the proposition this is a complex economic exercise. It isn't a question that can be dealt with on some kind of purely empirical exercise. And with respect one of the ways that can be identified is by looking at what the Commission was doing in the determinations that we are concerned with. And so I wanted to pick up, if I could, the general approach which has lead, in particular, to the scorched node decision. Now –

TIPPING J:
Could you, just for my benefit Mr Hodder, only me no doubt, explain exactly what this scorched node really means in the real world?

MR HODDER:
Well it's not in the real world, that's the problem, Sir.

ELIAS CJ:
It's in the virtual world.

MR HODDER:
It's half a real world.

TIPPING J:
Well remove the "in the real world", what on earth does it mean?

MR HODDER:
Well it is, I'll take you to the passage in a moment, Sir, but in short terms, when you're thinking about modelling costs, or you're thinking about assessing economic costs, one is you can try and empirically attract them by using accounting costs or whatever, one is you can simply assume away the entire existing asset base and put down a brand new hypothetical asset base, the most efficient technology, the most

efficient routes, ignoring history completely. That's scorched earth, because nothing is left to the old asset.

TIPPING J:

And that's different from scorched node is it?

MR HODDER:

Scorched node says, we'll break that exercise of scorched earth into two pieces and we will maintain the core network which goes out to the last switch, we'll leave that in place, because that may be an efficient thing to do. What we will do is we'll change from the last switch to the customer, we'll do that in the most efficient, with the most efficient technology, and so that last switch is what's referred to as the node, everything from the customer to the node is scorched, everything from the node –

TIPPING J:

Scorched, you mean eliminated from –

MR HODDER:

Eliminated for the purposes of the analysis.

TIPPING J:

Ignored.

MR HODDER:

For the thought experiment it's ignored, yes.

BLANCHARD J:

You're doing bottom up from that point on?

MR HODDER:

Yes, yes.

TIPPING J:

So you go with everything that actually exists out to the node, and then from the node onwards you put in place something different from what's actually there?

MR HODDER:

Correct.

McGRATH J:

Scorched earth modelled thereafter, for access, is that right?

MR HODDER:

Yes, it's a, so if you like, part of the earth is scorched, not the whole of the earth.

McGRATH J:

For access only?

MR HODDER:

Sorry?

McGRATH J:

For access only?

MR HODDER:

Yes.

ELIAS CJ:

That's a choice?

MR HODDER:

It is a choice.

ELIAS CJ:

Yes.

MR HODDER:

That's our point, why it's a question, not a question of law, there's a choice, and you can try historical.

ELIAS CJ:

Well it's not a question of law if it complies with the legislation, but it's a choice to have stopped there rather than take it right back to scorched earth.

MR HODDER:

Yes.

TIPPING J:

Would it be correct to say that you have the copper wire going out to the node and the wireless thereafter, for example. Is that how it – ?

MR HODDER:

That could be done. What –

TIPPING J:

But that's just an example of what might be the effect of this exercise?

MR HODDER:

Yes. And what the Commission did in those early determinations was to say, "We will assume the core network, i.e. out to the node, but we will treat other technologies beyond copper as relevant adjuncts to that core network, i.e. to get from the switch to the customer if they are more efficient in servicing the relevant cluster of CNVCs." And that's where the mobile technology debate came in, the question was whether that should be added and dealt with as an adjunct. And so the argument there is, one of the arguments there is, do you treat mobile technology as the way which it can be used as an adjunct, which gets you from the existing node out to the customer? Or do you treat it as an overlay network, which is what Vodafone is wishing to persuade the Court must be done. And I'll come back to that in more detail, but those are the two concepts in play there.

The Commission was prepared in 2003/4 to contemplate mobile technology as an adjunct to the core network but not changing the core network. Vodafone's complaint through to this appeal is that's the wrong way to think about it. Mobile is different. You have to assume a completely overlaid network and not stay with the existing nodes. But once you've done that, you're then scorching more of the network, which is why the proposition is what Vodafone really is talking about is scorched earth, but I'll deal with that in more detail as well.

TIPPING J:

Well you're both talking about scorched earth, it's a question of how far the scorching goes.

MR HODDER:

At one level that's correct, the – I'm not sure the cognoscenti is right, where you've described the Commerce Commission as the economist, but they tend to use "scorched earth" in a different way where scorched earth is meant to say everything is gone.

TIPPING J:

Mmm.

MR HODDER:

Whereas scorched node, only half of it is –

TIPPING J:

Who dreams up these expressions?

MR HODDER:

I'm not sure Sir, but – there's no identification of those.

ELIAS CJ:

We don't need to use them

TIPPING J:

No, we don't need – I mean it would be helpful to use something a bit more intelligible wouldn't it?

ELIAS CJ:

They're irresistible, however, aren't they?

MR HODDER:

What most of these, well potentially irritating phrases, it's hard to think of an alternative shorthand for them, and so as they've got some sort of defined use, then you might tend to use them. Can I ask the Court if it would please turn to volume 2 of the case on appeal.

ELIAS CJ:

Well why isn't the alternative to talk about an efficient service provider applied to both the node and the network?

MR HODDER:

Well –

ELIAS CJ:

I mean because effectively the decision means that we're not applying an efficient service provider standard to the core network?

MR HODDER:

Well, a couple of responses to that. The first is, it's not clear how you apply the definition directly if you simply say, let's apply an efficient service provider standard.

ELIAS CJ:

I understand that.

MR HODDER:

What does it mean?

ELIAS CJ:

Yes, that's not to give away your argument that there's a margin of appreciation because the terms are not capable of exact definition.

MR HODDER:

Sure. I'm not sure that it's quite so explicit in this. My understanding is that the scorched node approach has a logic to it on the basis that insofar as the core network is concerned, it's more likely to be the most efficient way to build that network.

ELIAS CJ:

If you assume the technology that the core network currently uses.

MR HODDER:

Yes, that is an assumption you'd have to make. The potent factor that the Commission adopted, you'll see, is the one that says if you don't do that and you require the TSP to simply write off that network, then the message you send is that there is a loss –

ELIAS CJ:

Yes I understand that argument.

MR HODDER:

– and that the incentive effect destroys the purpose of the TSO regime.

McGRATH J:

Mr Hodder, just while you're interrupted, can I ask you this, is the concept of a TSO one that necessarily relates to an end-user, in other words the obligations always extends to an end-user, rather than some intermediate point, such as a node?

MR HODDER:

As long as A plus B gives you the end-user, I think that's all that's required, so that would be the network plus the adjunct.

McGRATH J:

Right, so in any event your client's obligation under section 71 is to provide a service through to end-users?

MR HODDER:

Yes.

McGRATH J:

It doesn't stop when competitors come in, in other words?

MR HODDER:

No. Yes, the logic is in fact that competitors aren't coming in because it's not economic, so that's, that's sort of part of where it comes in the circle. Now, what I was going to suggest is that if we could spend a moment on the document at tab 28, if only because it has the advantage of brevity, compared with some of the other documents we'll have to consider.

ELIAS CJ:

Sorry which, which volume?

MR HODDER:

Volume 1, Ma'am, of the case on appeal, sorry, volume 2, tab 28. This is a document done for the Ministry of Economic Development which pre-dates the Commission's work, which the Commission refers to in its Cornerstone paper, which I'll come to and as I say –

ELIAS CJ:

Just as we asked Mr Gray to go first to the statute and then to explain the history, why is it not more helpful for you to take us to the decision and then explain, if you need to, what's behind it?

MR HODDER:

The reason I was taking you to this one, before I go to the decision where I'm going next, is that this is probably a more succinct way of describing the same issues that the Commission is dealing with in its decision, but I –

ELIAS CJ:

Well, anything that will help, I suppose we shouldn't reject.

MR HODDER:

Well, I, it, not that I can guarantee Ma'am, but I'm hopeful that it's of some utility in dealing with basic proposition which is the economic complexities involved in the exercise as such that this can't be called a question of law and there's a useful, in our submission, a helpful discussion and possibly helpful because it isn't the Commission, that starts on pages 849 at paragraph 6 and goes on into paragraph 7, explain the reasons why these, this particular kind of pricing has long run into incremental cost pricing, which is used in access issues –

ELIAS CJ:

But this is about price regulation.

MR HODDER:

Well, it's about access pricing, well, you can use it for either and in effect, that's what the TSO leaves open, the idea of long-run incremental pricing.

ELIAS CJ:

But, it's a bit, it strikes me as being a very different approach if you are regulating for price control purposes, than if you are trying to assess the very specific smoothing out of pain in, under this particular provision.

MR HODDER:

This is not directly concerned with price control, it's more concerned with access, and the whole purpose of access, as it is with the TSO, is to identify efficient costs, efficiently incurred costs.

ELIAS CJ:

All right, well carry on for now, but I have a query about it, but however.

MR HODDER:

Right, so paragraph 1, we're talking a total service long-run incremental costs. That's long-run incremental costs are at the heart of the TSO exercise as well. That's one of the reasons why I'm taking you to this. Paragraphs 6 and 7 provide the sort of, as it were, an introduction to what's an overview level and then there is a relatively brief discussion which runs from pages 855 onwards, identifying some of the difficulties and some of the choices that have to be made.

Now the relevant section runs from page 855 in paragraph 24 through to 859 in paragraph 2.4. But you'll see that what the document is addressing is the question of asset valuation and identifies perfectly, you could say orthodox economic principles in paragraph 26, a method of asset valuation, asset valuation generally gives investors confidence that prudently invested capital will be maintained intact and provide sufficient revenue for the funding of any obligations imposed.

That's the prudent proposition. 2.1 goes on and talks about optimisation and prudence and capital efficiency, which are the very concepts that we have to be concerned with, and 29 and 30, these are talking about optimisation.

ELIAS CJ:

But we're not talking about the whole network and its profitability.

MR HODDER:

We're talking about –

ELIAS CJ:

We're only talking about providing the service imposed –

MR HODDER:

As an incremental part of a network.

ELIAS CJ:

As an incremental part –

MR HODDER:

Yes.

ELIAS CJ:

– of the network.

MR HODDER:

Yes, I hope I don't forget that.

ELIAS CJ:

But sorry, but this is looking much more widely, isn't it?

MR HODDER:

It's introducing the concepts I was touching on, it was introducing the concepts in a reasonably accessible fashion, as to what the Commission is addressing when it comes down to deal with the incremental aspects that this appeal is focussed on. And you will see, for example, in paragraph 30, the cost concept used that commits the recovery of un-depreciated capital previously invested efficiently by the network and, most importantly, it promotes the efficient investment in new capacity. Now that point is the Leitmotif, as it were, of the work that the Commission does in this area. That if you do not have something which promotes efficient investment in new capacity and the maintenance of the existing assets, then the regime will fail.

Paragraph 35 makes the point that this, that introduces a concept of asymmetry, although not in so many words, asset stranding may be faced by an unrelated firm operating on a competitive market. A regulated firm must be prevented from selling prices above cost before the asset is stranded, and that's the strategy an unregulated firm would use. So any kind of regulation does, and TSO isn't part of formal

regulation, it doesn't permit prices being charged at above cost to anticipate the fact that there may be a stranding.

Further, on page 858 and the introduction of the phrases scorched earth and scorched node in paragraphs 44 and 45. And so 45, having explained that what scorched node is, and saying it will generally have a higher cost than the scorched earth network, goes on at 46 to discuss the choice whatever the criterion, if it's simply to minimise the current cost then scorched earth is clearly the preferred approach, but the rationalisation in ensuring that the pattern of future investment is efficient, it's important to work out how that follows, and 47 sets out the proposition a scorched earth model would result in sub-, could result in sub-optimal levels of investment because the gap between what the TSP is actually operating and what the hypothetical new scorched earth network has is too great. And concludes that a proposition at 49, "It's crucially important to ensure that adequate levels of investment are maintained", but as you'll in the recommendations box the idea that the network model should be re-optimised at regular intervals.

Now all of that was discussed and elaborated in the Commission's Cornerstone paper which I don't propose to take the Court to.

ELIAS CJ:

I'm sorry, this paper –

MR HODDER SC:

Yes.

ELIAS CJ:

– was produced by –

MR HODDER SC:

By the MED at the outset of –

ELIAS CJ:

Of what?

McGRATH J:

Before the MED.

MR HODDER SC:

Before, sorry?

McGRATH J:

Produced for the MED.

MR HODDER SC:

For the MED before this process started.

ELIAS CJ:

What, but was this after enactment of the –

MR HODDER SC:

No this is in anticipation, well it's prior to the –

BLANCHARD J:

It's in August and the Act is December.

MR HODDER SC:

The Act is December.

ELIAS CJ:

I see.

MR HODDER SC:

It's part of the way in which the thinking about the Act was developed. So if I can then take the Chief Justice's hint and turn to the Commission's actual determination, which is at tab 6 in volume 1.

McGRATH J:

Does that mean the preliminary documents are not relevant as far as you're concerned? You've referred to them just very briefly.

MR HODDER SC:

Not especially, the discussions are carried through into these determinations. I mean there are a lot of documents but it would take a great deal of time to take you through them.

McGRATH J:

Yes. As far as you're concerned we can just look at the determinations themselves?

MR HODDER SC:

Yes, they are effectively, sometimes with cross-referencing, picking up the discussions in the Cornerstones paper and the Implementations paper.

McGRATH J:

Yes, thank you.

MR HODDER SC:

In terms of this discussion, can I suggest that we can start at page 114 under tab 6, and the Commission addresses the question of unavoidable incremental costs in this first heading. Paragraph 24 it says, "It regards unavoidable incremental costs as a difference between the long-run costs a efficient service provider would incur with and without the obligations imposed by the TSO instrument. This includes return on incremental capital required to meet the obligations as well as appropriate depreciation costs of those assets", and so on. So, to repeat that, we say that is not a matter that can be judged as a question of law, that's a matter of applying the appropriate judgments to quite broadly phrased concepts and broadly phrased language. An incremental cost should be the long-run incremental cost, which was the subject of the previous paper.

TIPPING J:

If, and I emphasise if, that does not accurately reflect the statutory definition, surely that would be a question of law if they would have misdirected themselves in law?

MR HODDER SC:

Yes if –

TIPPING J:

If, and I emphasise if?

MR HODDER SC:

If the statute gave some clarify to the point that said this was clearly – yes, I would agree with the point.

ELIAS CJ:

Where do they get in the statute, "with and without"?

MR HODDER SC:

That's how they identify –

ELIAS CJ:

Because with one can understand, because that's really what it's all directed at, but where does the without come from?

BLANCHARD J:

It's the comparison. It's the comparison.

MR HODDER SC:

Just to give the increment. The gap is the increment.

ELIAS CJ:

Oh, with and without, I see, yes.

MR HODDER SC:

I hesitated to use the phrase "counter-factual", as the Court's probably heard enough of that in another context, but so that's – as I understand the proposition, what the Commissioner's saying is that if you're trying to establish the increment, then with and without, which is another way of saying counter-factual.

TIPPING J:

It's really a fancy way of say "extra" isn't it?

MR HODDER SC:

Yes, Your Honour. Turning onto the next page, around paragraph 34, the Commission in this section very much echoes what's in the Cornerstones paper. And it addresses the very point that Vodafone continues to make in 35 by going on in 36 and saying, "The Commission's has acknowledged in the past that the level of efficiency in the model for TSP purposes is not the maximum level of efficiency," and that reference is to the Cornerstone paper at paragraph 160. The Commission recognised that the evolution of an efficient network design is restricted to some extent by past decisions and to take a current list constraint the hypothetical network

takes into account a number of Telecom's network characteristics. "Under the scorched node approach the cost of an efficient service provider are those a provider would incur in providing TSO services using best available technology but given the location of the TSP's current network nodes". At 37 it goes onto say, "Nevertheless there was some optimisation going on –"

ELIAS CJ:

But, sorry, is 36 not further explained?

MR HODDER SC:

It's fully explained in the Cornerstones paper but not in this paper. Would it be helpful to go back to the Cornerstones paper for another narration?

ELIAS CJ:

Well, the issue here is, is whether the statute requires, or permits, I suppose is better to say, permits the Commission to take into account a number of Telecom network characteristics?

MR HODDER SC:

Yes, that's one way of framing the issue, but the basic proposition is that the Commission has been given a –

ELIAS CJ:

Or whether it should simply be an efficient service provider which may or may not be Telecom's – have Telecom's network characteristics?

MR HODDER SC:

Yes. Jumping ahead slightly, the problem – yet again it become definitional because we finish up with efficient, and as the Court will appreciate from the submissions and perhaps from reading the determination itself, there's recognition of these different kinds of efficiency and the question –

TIPPING J:

I think we should have it directly addressed to us, everything that bears on this issue, because it seems to me, at least, to be very central to the whole issue as to whether they misdirected themselves. If there's something that's incorporated by implicit reference, then that surely –

MR HODDER SC:

I'm happy to do that.

ELIAS CJ:

Well, don't you have to start, though, with their earlier determination in which as I, my recollection was from the Judgments below that the Commission took the view that Telecom's network was an efficient service provider to efficient service provider standard?

MR HODDER SC:

I think it said the technology they were using was –

ELIAS CJ:

Yes.

MR HODDER SC:

– consistent with an efficient standard.

ELIAS CJ:

Yes.

MR HODDER SC:

Yes.

ELIAS CJ:

Well that's the issue, though.

MR HODDER SC:

Yes.

TIPPING J:

See, we've got here, haven't we, a mix of the hypothetical and the actual?

MR HODDER SC:

Yes, that's the nature of scorched node. It's not, it's still not the actual beyond where the nodes are located, it says you don't redraw the map, the roads don't get

replaced, the roads are still there, you still upgrade the technology within the network – you don't restructure it.

ELIAS CJ:

But why –

TIPPING J:

Well, it is central to the issue of whether it's scorched node or scorched earth –

MR HODDER SC:

I'm sorry, Sir?

TIPPING J:

Isn't this central to the issue as to whether the statute –

MR HODDER SC:

Absolutely.

TIPPING J:

– requires scorched node or scorched earth?

MR HODDER SC:

Well the proposition I'm putting to the Court is that this doesn't actually tell anybody that.

ELIAS CJ:

But why go this far and no further, what's the reason for stopping –

MR HODDER SC:

Because –

ELIAS CJ:

– at the nodes?

MR HODDER SC:

The Commissioner's attempting to balance the different kinds of efficiencies that it has identified.

ELIAS CJ:

Well where, it's not saying that there.

MR HODDER SC:

Well, it doesn't say that there but it goes on to saying that later on.

ELIAS CJ:

I see. Well, you'll take us to that –

MR HODDER SC:

Yes.

ELIAS CJ:

– but first, it is correct isn't it that the Commission in an earlier determination said that Telecom, Telecom's network was to efficient service provider standard?

MR HODDER SC:

I don't know that it says precisely that, I thought what it said was that the fixed-line network –

ELIAS CJ:

Yes, I'm sorry.

MR HODDER SC:

– was capable of providing efficient service standards. It doesn't actually –

ELIAS CJ:

Yes, yes. And then it goes away from that?

MR HODDER SC:

Not entirely.

ELIAS CJ:

Well the very fact that it goes to –

MR HODDER SC:

It goes on –

ELIAS CJ:

– scorched node suggests that.

MR HODDER SC:

Well it tests that, it tests the scorched node proposition by testing in relation to the part that is scorched whether or not it can be done more efficiently by these new technologies such as MAR or WLL –

ELIAS CJ:

Yes.

MR HODDER SC:

– as opposed to using the fixed-line approach that Telecom's network used –

ELIAS CJ:

Yes.

MR HODDER SC:

– I don't know whether it goes further than that.

TIPPING J:

Mr Hodder, I think what Mr Gray is effectively saying to his client is that it was an error of law not to go for the maximum level of efficiency.

MR HODDER SC:

And I'm sorry to be repetitive, Sir, the question is what does "efficiency" mean when there are several –

TIPPING J:

Well –

MR HODDER SC:

– different kinds of efficiency. One is a long-run efficiency, one is a short-run efficiency. If one says efficiency means lowest possible cost, in any event that's problematic, one might say scorched earth, if one has to have regard as section 18 has been interpreted as having regard to dynamic efficiency as well as static efficiencies, then that becomes a matter of judgments and tradeoffs, but if the point is

that one goes for the absolute lowest cost, the immediate lowest cost, then the price you pay as the previous in this one say, is you have no incentives for further investment in the network because there is no reason to invest.

ELIAS CJ:

But that might be why, when you're price-setting, of course you would take the historic position into account, but this is a – this isn't an exercise in which they're looking at all Telecom's revenues. It's only looking at the substitution for the Kiwi Share. And why is it consistent with the statutory policy not to expect that that be at lowest efficient provider cost.

MR HODDER:

Well the short point is you won't have any TSPs.

ELIAS CJ:

Well yes, you'll have Telecom won't you?

MR HODDER:

Well you have a captive, but you – well with respect, the logic would destroy the voluntary incentivising aspects of the TSO regime is clearly contemplating.

ELIAS CJ:

But you're suggesting they haven't turned up anyway, except in respect of hearing.

MR HODDER:

There is one. But again in terms of interpretation –

ELIAS CJ:

Right.

MR HODDER:

– we say there can't be any argument, but that the Act contemplates there will be other TSPs, it doesn't frame solely in terms of Telecom's previous KSO obligations. So there has to be something which encourages the prospect of these voluntary arrangements. If the entire approach is one which says nobody would ever go into one of these things, because they would be punished, effectively, by losing capital, then you have effectively gutted the whole point in Part 3. That's the argument that the Commission I think is advancing, and which we support as – and also Justice

Arnold makes the same point. Just bear with me for a moment, Your Honour. I think Justice Tipping asked if we have all the references, and I do happen to have a document which I can hand up, may be of assistance.

TIPPING J:

Well it's just that it says, "The Commission has acknowledged in the past", so presumably there's something in the past that discusses this.

MR HODDER:

Well if I can give copies up. There's a fairly intimidating amount of material, which is one of the reasons why there are 11 volumes, Sir.

TIPPING J:

We've got a huge amount of material, but I would've thought this was pretty central.

MR HODDER:

So this is something that we've done, but what we've done is gone through a series of issues, and identified the various publications from the Commission and identified the places where those matters are discussed, and at the moment we're looking at the third column in, that is to say the second populated column, "Scorched node", and although these are purely commissioned documents, so they aren't the exactly the documents I started with from the – for the MED, but you'll see its discussed in the Cornerstone paper and then all these other reports going the entire way through. Now I'm happy to take the Court through those.

TIPPING J:

Well maybe it's better to leave that to the Commission because they presumably want to have something left to say.

MR HODDER:

Well, let me if I may just press on with 2003/4, and I'll contemplate overnight whether it's useful to take you back to the Cornerstone papers, I'm not sure it has much –

ELIAS CJ:

I'll like you to take us though, just briefly, to the earlier determination.

MR HODDER:

2001 and 2?

ELIAS CJ:

Mmm.

MR HODDER:

That's going to be in volume 4 of the case on appeal.

ELIAS CJ:

So is it under the heading, "Asset Valuation"?

MR HODDER:

Your Honour's looking for the part that says that the Telecom network or an approximation of it will be efficient?

ELIAS CJ:

Yes.

MR HODDER:

The starting discussion is on page 1610. Where you see there's a discussion of just, of defining the efficient service provider. And so 39, "The efficient service provider is one to produce the given quantity and quality at the lowest possible cost." Recognises the evolution efficiently redesigned is restricted to some extent by past decisions, and then goes on to favour the scorched node modelling approach". And then there's an argument about whether or not, how far that departs from the real world, the Commission responds, "The network model does take account of the real world. First the Commission's modelling uses only asset technologies that are fully developed and already deployed on a large scale". And then it goes on to talk about the cable routing.

The asset valuation section starts at page 1619. And including the discussion of the net cost definition, and including the use of opportunity cost. So there's a discussion of which cost base to use between historic cost and optimised replacement cost and optimised depreciated replacement cost. And then in its conclusion the Commission comes down in favour of optimised as opposed to historic costs. The final section that may be relevant to the Chief Justice's question is at 1669. Which is an analysis

of Telecom's cost modelling. That's a discussion on how Telecom – at this stage Telecom had offered its own model rather than the Commission producing one, and the Commission goes through and explains what it regards as unsatisfactory about that model. It ultimately goes on to decide that it will have its own model, and I think the paragraph that may be closest to what the Chief Justice was looking for, may be at page 1687. At 457, paragraph 457, it talks about its draft determination and says, "That although the scorched node modelling approach permits full optimisation –

ELIAS CJ:

Ah yes, that is what I was thinking, thank you.

MR HODDER:

– the wire line copper pair remained the most efficient and best in-use technology platform."

ELIAS CJ:

For the TSO period?

MR HODDER:

Yes, that's right. But then it goes on to describe in 458 the price cap that it uses for wireless in paragraphs 458, 459 and 460. Though it's a slight –

ELIAS CJ:

Thank you for that.

MR HODDER:

– deviation from where I was –

TIPPING J:

I would just like a little help with paragraph 38, Mr Hodder.

MR HODDER:

38 of which Sir?

TIPPING J:

Of the document you've just been looking at, on page 24, 1610.

MR HODDER SC:

Paragraph 38, Sir?

TIPPING J:

Yes. It seems to be focusing on the particular TSP rather than the hypothetical.

MR HODDER SC:

It looks, well we're just going to look – as if we're looking at both.

TIPPING J:

Well yes, they certainly are. If the TSP were operating efficiently, now there may be nothing in this but –

MR HODDER SC:

Again, and I think, Sir, the answer is that there's two different concepts and two different efficiencies that they Commissioner's attempting to factor into its work in this area. The first is that an efficient service provider might, if you had a scorched earth approach, produce a lower cost figure, at least on one calculation, but if from the perspective of the TSP that is providing the service that is an effect punitive, then that's a check on the first proposition.

TIPPING J:

I suppose the ultimate question here is whether 39 is it – is permitted by the statute. In essence whether the "however" is permitted by the statute?

MR HODDER SC:

Yes, and again the proposition is that if one doesn't have regard to that, then one is not giving effect to dynamic efficiency considerations, or at least not sufficiently giving effect to dynamic efficiency considerations, and the incentives for further investment. And that's one of the reasons why we say the answer to that question, is there a sufficient regard being given to dynamic efficiency considerations, is not one that can be answered as a question of law. It's a question of judgment, in this case one that's given to the Commerce Commission.

I think I was, if it's convenient, I was at the 2003-4 Commission determination, that's in volume 1, tab 6, and I was around page 115, and I had said that this discussion about efficient service provider had, in part, built on some of the earlier papers, so

when in 36 the Commissioner says, "The Commission has acknowledged in the past," what it's talking about is this discussion, the Cornerstones paper, and that reference that I've given in the buff page I've handed up indicates the area where that's discussed in that particular document. And having drawn attention to it, it maybe convenient to take the Court to it, it's at tab 30 in volume 2 of the case on appeal. This is a discussion paper that came out in March 2002 before any of the determinations were made. The discussion is largely carried forward, what the Commission does is identify some of the concepts in the Act on around page 940. So it grounds itself in the Act. Discusses definitions at 941.

At paragraph 24 on 942, by reference to considering the costs of capital employed, a reasonable return on capital, and the Commission says that has the effect of ensuring a longer-term perspective to avoidable cost that's taken –

ELIAS CJ:

Sorry, where are you?

MR HODDER SC:

That's paragraph 24 on line 42. I would simply add that the longer-term perspective is also implicit in section 18, or rather it's explicit in section 18, that talks about the long-term benefits that are to be achieved. Moving onto page 944 at paragraph 36, the Commission sets out its list of criteria –

ELIAS CJ:

Why then is this exercise required to be undertaken annually?

MR HODDER SC:

Well that's when the money's collected.

ELIAS CJ:

Ah. Yes.

MR HODDER SC:

That may be rather brutal but that's – if one's going to have a reimbursement process there has to be regularity to it and it's a one-year regularity. So that's when the levy gets paid, to use the phrase that my learned friend Mr Gray used.

At 946 and the Court will have seen reference to this in at least Justice Arnold's judgment in the Court of Appeal, there's a discussion – unavoidable cost, and the Commission wrestles with that and comes to its conclusion at paragraph 45, "It's difficult to construe the term 'unavoidable' in such a way as to expand significantly the meaning of the remaining terms." So it's logical and consistent to interpret unavoidable as equivalent to incremental and, with respect, that's a – we say that's a perfectly sound analysis. "Incremental" in this context means things that can't be avoided, and the context is "would not be avoided by an efficient provider, operating in the context of Part 3".

ELIAS CJ:

Well that is to, if you say that it doesn't add anything, that is to say that efficiency means lowest –

MR HODDER SC:

No –

ELIAS CJ:

No.

MR HODDER SC:

–that's the trouble with efficiency, it's a more elusive concept than just to say it means lowest cost. That's where the two different time factors which we have to consider, they crop up in various ways but obviously assets last for more than one year, but the TSO period is one year or the calculation period is one year. Likewise the investment that is being considered is incentivised by matters that take into account more than one year, whereas your shortest term costs are taken in the one-year timeframe, and it's the attempt of the Commission to balance those different concepts of efficiency which drive the exercise it's engaged upon. So unless it's possible to say that efficiency does not include dynamic efficiency, which is what the Commission and I would respectfully, most of the commentary is the most important form of efficiency, then they're entitled to have regard to the longer-term factors. If they do that then there are a whole series of tradeoffs and questions of judgment which can't be defined as questions of law.

ELIAS CJ:

Dynamic efficiency, sorry – remind us – is it used in the statute?

MR HODDER SC:

No.

ELIAS CJ:

No.

MR HODDER SC:

It's one of the recognised aspects of efficiencies of the kind that are embraced by the language or the word "efficiency" as in section 18.

Now, Your Honours, the scorched node or scorched earth approach discussion, the Cornerstones papers is pages 9 – are at pages 969 to 970.

ELIAS CJ:

Sorry, what page?

MR HODDER SC:

It's 969, Ma'am.

ELIAS CJ:

Thank you.

MR HODDER SC:

And this is what's picked up in the 2003/04 determination as I said. So 158, the Act requires only the cost to an efficient service provider be included in the TSO calculations – so far, so good. With regard to capital cost, this means the Commission must determine what an optimised network would look like, given the location of the TSP's customers and exogenous factors such as terrain. This section considers the question of the degree of optimisation the Commission should undertake. With respect, the very second sentence, what an optimised network would look like, cannot be a question of law. But that is in a sense the core question which takes us back to Justice McGechan's paragraph 62. So 159 then says if we do a complete optimisation, you would start from the current geographical distribution of demand and plan a new network assuming the use of modern equivalent assets. Required rate of service at lowest costs, known as a scorched earth approach because a resulting network is reconstructed as if no traces of the existing network existed. The alternative is a scorched node approach, in which the location of key

elements of the existing infrastructure are taken as given. The nodes such as network switches and points of interconnection.

ELIAS CJ:

When they say "typically", what are they referring to there?

MR HODDER:

Because this is kind of a well-known problem all around the world.

ELIAS CJ:

Well yes, but in what context? In the context of price setting?

MR HODDER:

And access. Which may be the same thing.

ELIAS CJ:

Yes, that's what I'm just pondering.

MR HODDER:

But the point that was raised by my learned friend as well, in our submission there's not only different rules for price fixing than there are for at the end of Part 3. We're still using the same basic economic concepts of costs, efficiencies, all those concepts which come through throughout the Commerce Act and indeed it's –

ELIAS CJ:

But you might, because it's directed at a more discrete and minor element of the whole. It might be that the statute is more extreme.

MR HODDER:

I think the argument for that would be stronger if weren't for the incorporation of section 18, which is what governs the Part 2 provisions about access, which was form of price control as well as Part 3. But when section 84 makes section 18 a mandatory consideration, and that's the very thing that governs Part 2, the submission of course must be that that indicates there's a degree of harmony rather than a degree of discordance between those parts of the Act. And that's the very role of bringing in section 18.

And then section 162 was making the point that I had been – sorry 161 and 162 go on to the next point. After saying in 160 that the scorched node network may produce a higher estimate of cost, then 161 the Commission says, "On what basis will the choice be made? The rationale for optimising network is the key, the rationale is to encourage efficient future investment by the TSP in relation to the provision of TSO services." So you don't leave the network as it is, you optimise it, because that does provide an incentive to efficient future investment.

162 goes on to explain how you can kill the prospect of efficient future investment. A common criticism of the scorched earth model can result in sub-optimal levels of investment. This is because the physical and notional networks can be very different under scorched earth optimisation, with a physical network by definition requiring more capital to construct – i.e. it's got the errors of history affecting it. We undertake an investment therefore of the TSP funded on the basis of a scorched earth model, receive a smaller return, that would be the case for the recovery of actual costs were allowed. Consequently if the pricing regime is sufficiently tight, upgrade investments that are desirable for the physical network may not occur because they exceed what would be required in a scorched earth model, and therefore will not be remunerated.

That's the incentive aspect which drives most of the Commission's reasoning on this topic. It regards, and we say quite properly, continuing investment and continuing incentives for investment as quite critical to maintaining dynamic efficiency. And that's inconsistent with the scorched earth approach. So 163 says, "Under a scorched node approach this concern is reduced. The TSP will still only be compensated for the capital required to construct an optimal network, but the design and cost of that optimal network will be more similar to the TSP's actual network and the capital cost that will be compensated for will be closer to its actual costs." It then goes on, "Internationally the scorched node method is preferred as it's seen as offering the best compromise between competing objectives". And can I say that that phrase captures the very point that that the *South Yorkshire* line of cases is addressing. Where the legislation requires a decision, make trade-offs or compromise between competing objectives, then it is difficult to say there is a definitive legal definition that applies to the outcomes.

And then 165, there's no precise universally agreed definition of the scorched node approach, the regulator is different with regard to questions around all of that. Ultimately the exact approach the Commission takes needs to be guided by an

assessment of the extent that optimising each aspect will lead to costs differing by an unreasonable degree from those faced by the TSP in practice.

That's the more detailed discussion which is picked up at paragraph 36 of its 2003/4 determination, which was back at page 115. At paragraph 38 on page 116, the Commission was still dealing with Telecom's point where it says, Vodafone's point, where it says, "Submissions arguing for optimisation to reflect the incremental costs of mobile networks are not aligned with the Commission's fundamental scorched node paradigm. This paradigm requires any optimisation of the access network to be integrated with Telecom's current network nodes. In these circumstances, replacement access technologies will have to be cost effective in delivering services as a supplement to a fixed network. In particular, optimisation which relies on economies of scale or low incremental costs derived from existing mobile networks to lower costs will not be accepted by the Commission". That, of course, is the subject of Vodafone's complaint. But just to reflect on what the Commission is actually saying: we have made a choice, and the question is, is the Commission entitled to make a choice in favour of scorched node?

Having chosen scorched node, then the question is: can you maintain the integrity of scorched node if you accept Vodafone's submission? And the answer has to be, "No". Because you don't maintain the nodes. The optimisation has to be done in a way that isn't adjunct to the nodes, because what Vodafone seeks, as you heard, is simply to use the overlay network. And Commission goes on to deal with that in paragraphs 39 and 40, addressing the issues and saying, in particular at 40, "The efficient costs of access networks should not reflect those of the overlaid mobile networks. Such an approach would, in effect, model of the outcomes of a tender process... and would depart too far from reasonable standards of efficiency previously adopted by the Commission." And then going on to the other point, "Given the essentially non-commercial nature of the service being delivered, the Commission considers that some reasonable bounds need to be placed on the attempt to approximate the cost that would be incurred in a competitive environment. The Commission will accept the lowest cost technology consistent with the scorched node approach." And that's –

ELIAS CJ:

Sorry, there's no indication there of why modelling a tender process for delivery of the TSO is rejected beyond saying that it would depart too far from what the Commission's done before, was there any more?

MR HODDER:

It would depart, the tender would be an invitation for all technologies to be put in.

ELIAS CJ:

Yes.

MR HODDER:

Which would defeat the decision not to go with scorched earth.

ELIAS CJ:

Yes. But does this amount to anything more than saying, "In order to maintain consistency with what we've decided, we reject the submission"?

MR HODDER:

Well, that's the principle version, that's it's having made the decision in principle –

ELIAS CJ:

Yes.

MR HODDER:

– to have scorched earth and this wouldn't be consistent. The practical one is the one that Justice Arnold relates to, which is you'd then have to model not just the fixed network, you'd have to model Telecom's –

ELIAS CJ:

Yes.

MR HODDER:

– mobile network for efficiency, you'd have to model Vodafone's mobile network and anybody else's, so you'd have to effectively conduct a virtual tender by seeking information from various people before you could make a decision. All within 180 days. And so the proposition is that that becomes an impractical burden.

The next part of this decision that addresses these issues is perhaps picked up in – on from page 138. At 138 the heading is, "Commission's Cost Modelling". It explains at 185 where the costs of the TSO arises from. 186 refers to the fact that it has to identify commercially non-viable customers, and that requires modelling efficient costs and revenues. Some of the principles I dealt with earlier, that's the passages we looked at. And then there has a series of other issues, top down versus bottom up, which probably doesn't need to concern us, but the difference between Telecom's model which was rejected by the Commissioner and the Commissioner's own model is the difference between top down and bottom up.

Then the degree of optimisation is addressed specifically from paragraphs 191 onwards. How efficient the model network design is compared to that currently existing. And it goes on again to describe scorched earth in paragraph 192. 193 sets out the Commissioner's position in favour of scorched node. So at line 4 of paragraph 193, "Therefore the Commissioner has adopted a scorched node approach optimising the network architecture around existing nodes, considering the range of best in-use technologies". And then it concludes at 141, paragraph 206, "The specific modelling approach adopted for the TSO period has been driven by and is consistent with the Commissioner's positions on the key modelling options above. This approach involves a choice of architectures and technologies consistent with likely investment decisions of an efficient operator during the TSO period."

This is where the Commissioner addressed it in the 2003-4 and sort of attempts to summarise this. What it has been saying is that one is looking for upgraded investments in the physical network, they will be disincentivised if there is no remuneration because of the differences between a notional network and a physical network. The scorched node approach reduces that concern and is preferred. The Commission finds that that is reflected in international practice as a compromise between competing objectives. And the exact application will depend upon maintaining a reasonable degree of relationship between the costs of the actual and the cost of a notional network. It is also recognised in the non-commercial nature of the TSO services themselves.

Now our submissions are very largely echoing the logic that's used by Justice Arnold in the Court of Appeal in relation to this, and it may be sensible to go through that. Now the Court of Appeal's decision is in volume 1 of the case on appeal at tab 3, page 9. And the essential, the analysis that Justice Arnold undertakes I think is

common with the analysis I'm suggesting, that in the end he's asking whether or not there's something unreasonable by what's been done because there is no right answer in relation to net cost and therefore it's a matter of judgment. The passage which is critical in the judgment, and which is the part which is agreed to by Her Honour Justice Glazebrook, really runs from paragraph 117 on through to the end of the judgment. And so at 120, on page 51, Justice Arnold agrees with the Commission when he states that the word "unavoidable" doesn't expand the meaning of the remaining terms and the definition. And goes on and discusses the previous determination, also makes reference to the Telecom and Clear litigation and at 121 he says, "As is apparent, the concept underlying 'incremental cost' is that if the additional increment is not supplied, the relevant incremental costs will not be incurred. In that sense incremental costs are avoidable". And we –

TIPPING J:

Didn't the Commission say that although it was a well established term in economics, it wasn't established what it meant?

MR HODDER:

They may have said that, to the extent they did, I think –

TIPPING J:

I seem to remember they said it could mean three things, any one of three things, and they then went on to discuss which of those three was the more or most appropriate for this context.

MR HODDER:

That's correct, although presumably the Judge we're looking at, the judgment we're looking at, is simply going to the view that's preferred, and so we say that those first two sentences are entirely cogent and that are trying to –

TIPPING J:

But it portrays the view that this is, it's well established that this is what it means. But I didn't get that impression at all. I got the impression that it was a term known in economics but its meaning was contestable.

MR HODDER:

I think the Judge, well the Judge is citing from the earlier High Court litigation in the Telecom and Clear case, where there was a discussion about incremental costs for the purposes of access.

TIPPING J:

Well I was referring to the Cornerstone paper, where I seem to remember that there were three possible meanings that they discussed, or have I got that wrong Mr Hodder?

MR HODDER:

I didn't focus on that, Sir.

TIPPING J:

No all right, well –

BLANCHARD J:

I think there was a passage –

ELIAS CJ:

I thought it was in the decision.

TIPPING J:

We've read it somewhere within the last –

MR HODDER:

I don't doubt it. I think what the Judge is simply saying if one looks at the way in which it's been used in previous New Zealand jurisprudence in that area, then one finds it has gotten used in terms of the access debates because that was all about costs, what were the opportunity costs and how could they be assessed and were they reasonable.

TIPPING J:

All right, well that may be just a irrelevancy, I'm sorry.

MR HODDER:

No, not at all. If there are choices, then one has to make them.

TIPPING J:

It struck me as being arguably rather simplistic. See we've got two layers, we've got what does incremental costs mean and then what does unavoidable incremental costs mean?

MR HODDER:

And I accept that what the Judge is saying in the Court of Appeal is that you don't actually get much value out of unavoidable. That maybe a consequence, sometimes it happens. In our submission one doesn't strive to find some separate meaning for unavoidable, when incremental incorporates the concept of unavoidable.

ELIAS CJ:

Well, you could have incremental costs in providing the service and you could have a choice of ways in which to deliver them –

MR HODDER:

Yes.

ELIAS CJ:

– and one might be, I suppose you don't want me to say, cheaper?

MR HODDER:

Well I mean you could have bells and whistles –

ELIAS CJ:

Yes, exactly.

MR HODDER:

– of various kinds, which is Your Honour's point, but the approach the Commission has taken is, a with and without approach, would be designed to avoid that and if you were saying, if one says unavoidable means you don't have bells and whistles on your with approach, then there's no objection to that, but I don't apprehend that to be the issue between the parties.

BLANCHARD J:

The passage that Justice Tipping was looking for is in the Cornerstone paper at page 946.

MR HODDER:

Yes, and I have apprehended that what Justice Arnold is doing, is going onto the next paragraph from the Cornerstones paper and agreeing with it.

TIPPING J:

I've misled myself, I thought it related to incremental but the discussion was in relation to unavoidable.

MR HODDER:

Unavoidable, yes, I thank you. And then what that leads to is the next paragraph in the judgment, where he records that Vodafone's argument doesn't depend on unavoidable but really it's about the lack of the cheapest option and then the response comes at paragraph 123. "It can't be said that simply because the Commission cannot produce the lowest possible net cost figure, its analysis is a matter, wrong as a matter of law. In formulating its approach the Commission had to make a variety of decisions, with varying impacts on the net cost calculation. At these various decision points, or some of them at least, the Commission could have made different choices which would have had different effects on the net cost figure. In short, there was a range of legitimate choices open to the Commission". Now again that's the very language that one gets from *South Yorkshire* et cetera and I repeat that what those choices relate to, in part, a very large part, is the incentive and dynamic efficiency aspect on the one side versus the least cost and the short-term on the other.

Maybe it's convenient if, Your Honours, just to, I see it's just about time to close, but what I'll do is take you back to paragraph 76 on page 34 where Justice Arnold is citing from the Commission's earlier guide document about the three types of economic efficiency, allocative, productive and dynamic. Recording that allocative efficiency is difficult to apply because of the high fixed and common costs and therefore marginal costs are not a useful way of assessing the matter and that there may be tensions between allocative or productive efficiency on the one hand and dynamic efficiency on the other, which means that tradeoffs must be made. In that

context time provisos may be important. That is the point that really underlines this much of the debate in relation to Vodafone's appeal.

I see it's a little after four, if it's – if the Court wishes to rise?

ELIAS CJ:

We'll take the adjournment now. Where are you going to go after this, Mr Hodder?

MR HODDER:

What I wanted to do was to finish discussing the Court of Appeal judgment, but that won't take very long, and then I wanted to invite the Court to accept that there was nothing wrong with the *South Yorkshire* line of authority and that was all I was going to say about the Vodafone appeal, then I was going to move onto the NPV=0 aspect which comes more towards our appeal.

ELIAS CJ:

Yes, thank you. All right, we'll take the evening adjournment and resume at 10 tomorrow.

MR HODDER:

As Your Honours please.

COURT ADJOURNS:4.03 PM

COURT RESUMES ON TUESDAY 22 FEBRUARY 2011 AT 10.00 AM

ELIAS CJ:

Thank you, Madam Registrar, we're all here. Yes, Mr Hodder, where are you at now, are you just about to go on to the second appeal, or are you –

MR HODDER:

I hate to dash optimism so early in the day, Ma'am, but no.

ELIAS CJ:

There is actually a matter I would like to raise with counsel and that is, if it is humanly possible and I don't want to put the parties and their counsel to any inconvenience, I would very much like to attend a funeral in Auckland tomorrow afternoon, which

would mean, I'm afraid, that I'd probably have to leave here at the morning adjournment. Now we could, I haven't discussed this with my colleagues, we could start early and we could sit later perhaps, if that suited.

BLANCHARD J:
Not today.

ELIAS CJ:
But not today, no, so could perhaps you confer over the course of the morning and tell us what suits. If we are not going to be able to finish if we take that big chunk out, then I certainly wouldn't do it. Thank you.

BLANCHARD J:
And we will have to rise a little bit early this afternoon.

ELIAS CJ:
Will we?

BLANCHARD J:
I'm having an operation.

ELIAS CJ:
Oh, sorry, what time?

TIPPING J:
They're sharpening already.

BLANCHARD J:
4.15.

ELIAS CJ:
4.15, all right.

BLANCHARD J:
So we have to rise at 3.45.

ELIAS CJ:
All right.

MR HODDER:

The incentive to brevity noted all round. What I thought I would do, if it is not repetitious, is explain where I think we are and then explain what I have to do first. I'm afraid I'm still on the first appeal and what I wanted to do was really address squarely the question which I think was being put in various ways by at least the Chief Justice and possibly some of the rest of the Court yesterday, is why not scorched earth, why don't you just read the Act as saying scorched earth. I wanted to address that directly and I think the answer to it deals with most of the rest of the first appeal and then after that I would then proceed to deal with the second appeal, which gets us into the joys of titled annuities which isn't entirely straightforward and then the third appeal, asset beta is a positive breeze by comparison. But that's, that's all by way of advanced mitigation –

ELIAS CJ:

Terror, yes.

MR HODDER:

– about the fact that you'll be listening to me for much of the day I'm afraid.

ELIAS CJ:

Quite.

MR HODDER:

So can I start with, and I also want to take up a point of giving you some of the background references as to how the Commission and then the Court, and the Court of Appeal, got to where it was, but the first question is, why not scorched earth, isn't that ensuring the least cost? That seems to be the approach that Winkelmann J took in the High Court and the answer that I wish to demonstrate through the way in which the Commission's approached it and say that it's consistent with the Commission's judgment or in an area of judgment and appreciation, is that it discourages future efficient investment in assets, because there is an ex ante risk of under-compensation and if you have that, then you don't get the investment. If you don't give the incentive, not only do you not get efficient investment, you won't get the takers for TSO regimes and Part 3 will be effectively a dead letter, apart from those that are trapped already.

Now if I can start, there's a sequence I'll take the Court through briefly. Some of these references in the page I handed up yesterday –

McGRATH J:

At some stage will you be taking us to that part of Justice Winkelmann's judgment that you are critical of?

MR HODDER:

Yes, I, what I propose to do is to go through the Commission's work and then go through, both the Court of Appeal and Justice Winkelmann's propositions. But can I say now that what I'll be saying about Justice Winkelmann's judgment is that there is, in our respectful submission, a fairly fundamental misconception there. She's very much focussed on what she described as Telecom's actual costs throughout and we say that simply what the issue is about, and if you correct for that then the rest of the reasoning in fact –

McGRATH J:

Cost employed, meaning actually employed, I think is the way she looks.

MR HODDER:

That's not, that's not clear that that's what she either says or what she intends from that judgment.

McGRATH J:

Well, that, I'm sorry –

MR HODDER:

And that's her concern.

McGRATH J:

– but you've removed my misconception at some stage.

MR HODDER:

Yes, so that's where I will be coming to Justice Winkelmann, but I'm sorry that's a bit later in my sequence if I –

ELIAS CJ:

That's fine.

MR HODDER:

– follow that sequence. So can I start with the Cornerstone paper, which is in volume 2 of the case?

ELIAS CJ:

Is there anything more on the statute that you want to refer us to in relation to the submission that scorched earth would discourage future efficient –

MR HODDER:

It's all tied up in the word –

ELIAS CJ:

– operation?

MR HODDER:

– efficient, where it appears twice, once in the definition of net cost and once in the section 84 reference back to section 18.

ELIAS CJ:

Yes, there's nothing more than that?

MR HODDER:

No, although it's also tied up with the long-term benefit aspect of section 18 and generally –

ELIAS CJ:

Long-term benefit to consumers.

MR HODDER:

Yes, which means you have to have a network there for the long term, rather than drive it into the ground by getting cheap prices for the first few years. So we say that that gets you away from the one-year timeframe, the collection of the money on the annual basis. If you take into account long-term considerations, you're taking into account the range of efficiencies, then that's what drives the Commissioner's reasoning and we say it's perfectly legitimate.

ELIAS CJ:

Because it seems to be quite a powerful argument you make that Part 3 would be a dead letter except for those already trapped in it, are you going to explain how any further – and it may be that you don't need to – how Part 3 applies to those who come on board voluntarily? Would it not depend on the terms of their TSO Deed?

MR HODDER:

In part, but in part you can never predict the future –

ELIAS CJ:

But is it –

MR HODDER:

– and if the net cost is always determined by the Commission, that's going to be the critical factor.

ELIAS CJ:

But that's for the evening out of the pain, that's why it's determining the net cost. Is it possible, I'm not sure whether it is, under the scheme of the Act, for an incoming provider to receive a, for there to be an agreement that it obtains a set return –

MR HODDER:

Yes.

ELIAS CJ:

– under the deed?

MR HODDER:

That's one of the alternatives.

ELIAS CJ:

I see, so it's not necessarily the case that Part 3 will become redundant because a party coming in may, may provide for its own return, it's just that Telecom is saddled with this obligation, is that right?

MR HODDER:

Not, no I don't think I can accept that as a full proposition. The Act undoubtedly contemplates two kinds of TSO instruments.

ELIAS CJ:

Yes.

MR HODDER:

One will have a specified sum and the other depends on a net cost calculation being undertaken by the Commission. If you have a short-term arrangement that will provide you with, let's say its services for the deaf for one year or two years, then you might contemplate that that's relatively manageable, in terms of saying, pay me a million dollars a year or whatever the number is and no ifs and buts and so on, so forth. If it's a longer term process, there's a more major investment in the network that is going to last on for years, then putting in a fixed sum that doesn't have some adjustment arrangements or doesn't reflect net costs is going to be incredibly difficult.

ELIAS CJ:

But the provider could provide for that in the deed, that is possible?

MR HODDER:

It's conceptually possible.

ELIAS CJ:

Yes, I see, thank you.

MR HODDER:

But the same issue would arise because in effect you would need to have some adjustment for time at some point and either you negotiate that in advance or it's dealt with ex post by the Commission's work under sections 84 to 92.

So "dead letter" may be slightly overenthusiastic advocacy in the sense that it's possible for that part of the TSO to survive, if one can calculate it and deal with it in the deed and it's accepted, but in terms of the clear part of the Act that's directed to the idea that the Commission has a role to play in long-term investments, then it would, I don't resile from the dead letter characterisation for that part.

ELIAS CJ:

But the Commission's function is in terms of spreading the burden.

MR HODDER:

In relation, it's one of its two functions. In relation to the agreed at the outset sum or contribution, yes, it's only dealing with the second one.

ELIAS CJ:

Yes.

MR HODDER:

It also has to assess compliance.

ELIAS CJ:

Yes, yes, I understand, thank you.

MR HODDER:

I was about to turn to the Cornerstone paper if I could. This is a chronological sequence, so I apologise, there may be some degree of repetition. That's to be found at tab 30 in volume 2 on the case on appeal and firstly, turning to page 944, there's a discussion there about the purpose of the Act. From paragraph 32 onwards, the Commission is referring to section 18 and at paragraph 33, the last sentence, the Commission says, "In practice all aspects to the Commission's approach, estimating and allocating the cost, must be made in a manner that is consistent for that purpose, i.e. section 18." And then at 35, the Commission goes on and says, "The key impact of the section 18 purpose statement on Part 3 is to require the Commission in making determinations to minimise any distortion to the competitive process, or to efficient investment." And we said that's an entirely justifiable proposition on the strength of the Act, you recall that Part 2 of the Commerce Act is excluded and so it has to have regard to the competitive process, an efficient investment is, we say, previously contemplated and long-term arrangements and efficiencies referred to in section 18. Then at 36 it goes on and says what it's proposed list of criteria are when it tries to apply these purposes and the bullet points 2, and 3 and 4 are relevant to the incentive long-term aspect of what I have been indicating to you.

ELIAS CJ:

I'm sorry, I'm just trying to understand, I don't think anyone would have any difficulty with that statement in para 35, but to what extent is the obligation imposed on Telecom because the – because we don't have a competitive market for historic

reasons. I'm just trying to work out whether there is a specific regime here, which the statute contemplates, which doesn't mean –

MR HODDER:

For Telecom alone?

ELIAS CJ:

Yes, yes in this – well in part.

MR HODDER:

We would say, no there can't be.

ELIAS CJ:

No, I see, because you say –

MR HODDER:

Net cost has to be net cost, there can't be net cost for Telecom and then another net cost for everybody else. Or least an analysis on that cost.

ELIAS CJ:

But the ability to spread the cost to competitors, what's the purpose of that?

MR HODDER:

It's a way of distributing back to end-users the cost, so you start with the social policy that people who would otherwise –

ELIAS CJ:

But surely it's there because there are some imperfections in the competition provided by the existing industry.

MR HODDER:

Not necessarily.

ELIAS CJ:

Why?

MR HODDER:

The efficiency would be that if you have – that's why you have the sort of the cherry-picking aspect of competitive activities. The classic example given in this area is normally servicing remote rural customers. If you were a new entrant, the last person you want to serve is somebody up in the remote areas, you want to serve the people in the central city areas.

ELIAS CJ:

Yes.

MR HODDER:

And so what the TSO does, what the original KSO does, is said, "No, no, we're going to have a flat rental on free calls for everybody in the country". That's inherently uneconomic or inefficient, and then what happens is a way of balancing that across end-users.

ELIAS CJ:

Yes, it's the social purpose point you were making.

MR HODDER:

Yes.

ELIAS CJ:

Thank you.

MR HODDER:

The next part of the Cornerstone paper I draw your attention is at page 969, which again is where it comes back to the scorched node, I think we got to this yesterday, but the paragraphs 161 and, through to 163, are explaining that it's the investment factor that drives the Commission's choice between scorched earth and scorched node, and in particular 161, "On what basis do you make the choice? The rationale for optimising the network is the key... Its purpose is to encourage efficient future investment by TSP", and it's the word "future" which I would emphasise because it ties in the long-term factor.

ELIAS CJ:

Sorry, what paragraph are you at?

MR HODDER:

Page 969 –

ELIAS CJ:

Yes.

MR HODDER:

– paragraph 161.

ELIAS CJ:

Thank you.

MR HODDER:

And then at 162 it notes the concern at the end of that paragraph, "If the pricing regime is sufficiently 'tight', upgrade investments that are desirable for the physical network may not occur because they exceed what may be required in the scorched earth model and therefore not be remunerated." And 163, "Under a scorched node approach, this concern is reduced. The TSP will still only be compensated for the capital required to construct an optimal network. However, as the design and cost of that optimal network will be more similar to the TSP's actual network, the capital costs it will be compensated for will be closer to its actual costs." And at 164 it says, "Internationally, this is preferred." And then it concludes at 164 by saying, "It's crucially important to ensure that adequate levels of investment are maintained and a scorched node model is more likely to serve this objective..." So that's the way the Commission addresses in the Cornerstone paper.

Can I turn then to the next in the chronological sequence I want to refer to, which is volume 3 of the case on appeal, and this is a document called "The Guide" which is at tab 32. It's directed to access determination, which is part –

ELIAS CJ:

Sorry, can you explain paragraph 163 where it says that the TSP will still only be compensated for the capital required to construct an optimal network?

MR HODDER:

Yes, because what is happening under the scorched node model is firstly that you have optimised the technology from the switch to the customer –

ELIAS CJ

Yes.

MR HODDER:

But within the network itself you are using replacement cost, which will be the optimal equipment required to replace it. You don't use the old equipment.

ELIAS CJ:

Always?

MR HODDER:

Yes. That's part of what the Commission does. So it doesn't say if you have to buy the technology that was available 10 years ago or 20 years ago and replace with that technology it might cost more, and if you buy the more efficient one it says, "You must buy the most efficient one" inside the core network. So there's two things going on in the optimisation and improvement processes. One is new technology entirely in relation to the new ways of doing it, potentially in relation to the outer area from the switch out to the customer, inside the core network it's the optimal replacement cost, what will be the most efficient way of replacing what's there.

ELIAS CJ:

So it's not an optimal network, it's the optimised network?

MR HODDER:

That's probably – I'm not sure if there's a big difference there. I mean optimal network in one sense I know implies scorched earth –

ELIAS CJ:

Yes.

MR HODDER:

Within the confines of scorched node it is not the actual network, it is still a notional network and it's been optimised in the ways I've been describing.

ELIAS CJ:

But is this not consistent with the Commission then reasonably taking the view that the copper wire delivery was optimum?

MR HODDER:

Yes, it's not just copper wire –

ELIAS CJ:

Well or whatever your core network is.

MR HODDER:

The answer is, yes the Commission does come to that view, but within the network, the core network there's a whole series of components, it's not just the copper wire in the trenches and this process applies across the entire range of assets that make up the core network. So I don't know there's any difficulty about the proposition that Your Honour's putting, which is the Commission recognises that within the core network, broadly speaking that technology was the best available, but insofar as there was any room to improve it because prices were coming down or some such, then that would be taken into account.

ELIAS CJ:

Well what happens when that technology does get overtaken on your argument? Is the Commission then obliged to reconsider?

MR HODDER:

At some point there's a periodic overhaul of the model.

ELIAS CJ:

When?

MR HODDER:

That's a matter for the – well in effect, in legal terms, I'd say it's at the point where it goes beyond the point of being an acceptable model, so if I go back to where I started from, the Commission has to make a judgment, provided that judgment is not irrational or unreasonable.

ELIAS CJ:

Well suppose you had totally supervening technology?

MR HODDER:

Then there'd be a much better argument to say that a decision was completely based on a technology that is no longer being used, was no longer in the legitimate range of options for the Commissioner.

ELIAS CJ:

I see.

MR HODDER:

But that's not the argument here, unless you accept the overlay argument and the scorched earth approach.

ELIAS CJ:

Yes, well it's the "unless" that we're really dealing with.

MR HODDER:

And even then I don't know that's exactly what Vodafone is contending for, I'm still not entirely sure that Vodafone still says it supports scorched node or not, but if it does –

ELIAS CJ:

It did say that.

MR HODDER:

Yes. Well it said that in most of the Courts below, I thought the position yesterday was, with encouragement from the Bench, my learned friend was moving towards the idea of adopting scorched earth, which then would be a different categorisation.

ELIAS CJ:

Yes, I was just really trying to understand what the statute requires.

MR HODDER:

Well my point is this actually doesn't tell us.

TIPPING J:

Well the statute requires unavoidable costs to be assessed, whether costs are avoidable or not, must take, or you must bear in mind investment efficiencies and

incentivising future investment, is it really that is – well it's not an error of law to bear that in mind, that's the key point isn't it?

ELIAS CJ:

That's his argument.

MR HODDER:

And the only thing I'd add is that you read that phrase in section 5 definition as a composite phrase, you don't pick out word by word.

TIPPING J:

And one of the key points for me is whether unavoidable cost has been used by Parliament as a term of art in an economic sense or whether it's simply been used, you know, colloquially if you like. Now do we know that?

MR HODDER:

No, all we can do is know that as Justice Arnold said, we discussed briefly yesterday, incremental cost is a term known to economics –

TIPPING J:

Yes.

MR HODDER:

– and incorporates an assumption of unavoidability, like you can't avoid these costs to produce one extra unit of product, but it's why the Commission and the paper we were looking at yesterday has these three versions about what unavoidable might mean because it isn't an economic term of art.

TIPPING J:

And we've got nothing, as I understand it, to give us any guide as to what Parliament was intending, if I may use that word, by the addition of the word "unavoidable"?

MR HODDER:

No.

TIPPING J:

And is that close to the heart of the dilemma?

MR HODDER:

For brevity's sake the answer's probably no in the sense that one doesn't need to have, in our submission, because the section 5 definition is simply one of the overall Part 3 relevancies that I was going through yesterday. It's just one of the considerations that has to be borne in mind and so it's –

TIPPING J:

Well speaking for myself, Mr Hodder, I think this is close to the heart of it. Because Justice William Young seemed to be very much of the view that the key word was unavoidable, and you know if that's right maybe one consequence will flow but if it's not right, if it's surplusage in effect, then another consequence might flow.

MR HODDER:

I agree if it's a critical word and there is a, a clearer definition that can be given to it, and it's relevant to what we're talking about then that will obviously be important, but we resist each of those propositions.

TIPPING J:

You want to make this as complicated as possible, don't you?

MR HODDER:

I was trying to decomplicate it by removing unavoidable as an extraneous object. It's simply part of the context with the definition of section, of the cost.

TIPPING J:

Well the more complicated it is, the more you're able to say, oh well the Commission's an expert body, they must have got it right?

MR HODDER:

That's true, but section, sorry Part 3 is complicated, that's the essence of it, it's not just about net cost, it's about net cost and the concept, and the context of Part 3 –

TIPPING J:

Yes.

MR HODDER:

– having regard to section 18 –

TIPPING J:

Yes.

MR HODDER:

– and once you do that you don't have a simple answer or simple question anymore, that's the argument –

TIPPING J:

We shall see.

MR HODDER:

And the, is there anything else on the Cornerstone document before I move to the Guide?

ELIAS CJ:

No thank you.

MR HODDER:

So I was suggesting you looked at the Guide, which is at tab 32 in volume 3. Now the Guide is in relation to access determinations and those, of course, relate to Part 2 of the Act and we're concerned with Part 3, but the common theme of course, or the common linkage, is section 18, purpose, which applies to both, and if I can ask the Court to look at page 1079, you will see there at paragraph 63 and following a discussion of efficiency and you will see –

GAULT J:

Could you repeat the reference please?

MR HODDER:

It's page 1079 of volume 3, and it's paragraph 63 – 1079.

GAULT J:

Thank you.

MR HODDER:

And so at 63 the Commission's asking, in a sense, the very question that we're addressing at this stage, what decision by it will result in competition for the long-term benefit of end-users, and this says, "the Commission must consider the efficiencies that may result", that's really a paraphrase of what section 18 requires. Then it goes on to describe the forms of economic efficiency: allocative efficiency that resources go where they're most usefully utilised, productive efficiency which is you have the lowest cost – and you'll see the phrase "least cost" is actually used in the definition of productive efficiency there. But then dynamic efficiency, where service providers invest, innovate and improve telecommunication services, increase productivity and lower costs through time, and again I'm sorry but we emphasise the time dimension. And the Commission goes onto say, "These are meant to be maximised in competitive markets and in some circumstances", I'm at paragraph 65, there may be tension in particular between static, which is the first two forms, and dynamic. "As a result, there may be tradeoffs in an attempt to promote efficient competition and the long-term benefit of end-users". And so the word "tradeoffs" is used again in 66. And then 68, sorry 67, tradeoffs may be particularly acute in relation to telecommunications networks because they're typically characterised by high fixed cost and low marginal costs and also there new technologies decreasing the fixed cost of constructing new networks.

Then 68, "Where there are tensions between short-term allocative efficiency and long-term dynamic efficiency, the Commission takes the view that the latter will generally promote competition for long-term benefit of end-users". And that proposition at 68 underpins the rest of the Commission's work and the argument again legally in this context is that that sentence is wrong as a matter of law, and in my submission that argument cannot hold. It isn't a question of law and in one sense it doesn't matter whether the Commission's right or wrong, but we would say everything points to the Commission being right.

ELIAS CJ:

What is meant by the second sentence in 67?

MR HODDER:

Well it's again another description of why tradeoffs are especially acute in telecommunications, and what I understand it to be saying is that new technologies tend to decrease the cost but extend the economic value of existing networks. The example might be the idea that you could use the old copper networks to get much

more information down them by using different technologies than was originally thought. So copper was thought at one point, not that long ago, to be going out of fashion, then it was discovered in fact you could use some different technologies and get much more information going down the copper than had ever been used historically and so that made the copper much more valuable again. I think that's what it's trying to capture. Generally, technological improvements mean that most things are coming down in value compared to their output, the sort of rule about computing et cetera that's increasing the productivity through the process, that's what the first part of the sentence is talking about.

ELIAS CJ:

But what's the second – I don't understand what is meant by, "while also extending the economic value of existing networks"?

MR HODDER:

Well as I say, my understanding is that that is an example where if you, while you have some new technology is that maybe you can use the existing physical assets.

TIPPING J:

They're new technologies that enhance the –

ELIAS CJ:

It's because new technologies are extending the economic value of existing networks.

MR HODDER:

Yes. It's the difference between a technology as a packaging of the information, for example, and using the physical assets such as a copper wire.

ELIAS CJ:

But it does mean that using radio, for example, built onto your copper wire distribution, may mean that you don't have to dig more trenches?

MR HODDER:

Possibly, yes. I don't dissent from that proposition. If it's convenient I would then move onto tab 33, which is the position paper and at page 1123, just briefly at paragraph 22, but again quite a fundamental sentence in the scheme of this appeal.

The Commission's view is that an efficient service provider is one that makes efficient decisions over time as to what services to provide and how to provide them. And we say again that that is giving effect to the language of efficient service provider that one draws from the Act by adding a time dimension, which then diminishes the focus that Vodafone and Justice Winkelmann would put on static efficiency and least cost. So again we say that the long-term context and dimension is extremely important in relation to this and then it goes on in paragraph 23 to say, "We've taken this into account when we talk about scorched node," and we find that discussion on pages 1128 and 1129.

The conclusion is at paragraph 41 on 1129. "The Commission recognises that the evolution of an efficient network design depends on past decisions. As a result, assuming that an efficient provider can continue to wipe the slate clean each year (as implicit under a scorched earth approach) runs a risk of under compensating the TSP for efficient investment." And then it goes on and notes that it has no knowledge of any other regulator estimating the cost of universal service obligations using a full scorched earth approach, and that's its conclusion.

Now, I'll come to the 2003/4 determination that we're concerned with in just a moment but, just pausing here, the point, and I'm sorry to labour it, is that in our argument the statements at 41 and 42, and indeed 43, are matters of judgment, they're not matters of law and there's nothing in the Act that is offended by the approach that's taken here or in the previous passage that I've referred to.

So if we turn then to the actual determination under appeal, which is in volume 1 at tab 6. This has got a little less to say on it than some of the earlier documents, but it's building on those earlier documents. So starting at page 115.

ELIAS CJ:

I'm, sorry, lost.

MR HODDER:

Volume 1.

ELIAS CJ:

Yes, of the bundle of authorities?

MR HODDER:

No, volume 1 of the case on –

ELIAS CJ:

Case.

MR HODDER:

– appeal. We're talking about the –

ELIAS CJ:

Yes.

MR HODDER:

– Commission's determination –

ELIAS CJ:

Volume 1?

MR HODDER:

Tab 6.

ELIAS CJ:

Oh, tab 6, sorry.

MR HODDER:

And there's a section starting on 114, identifying the net cost that we saw earlier, the discussion of unavoidable incremental cost. I was drawing attention to the discussion of efficient service provider that starts at the bottom of 115 and as I think we've said yesterday at paragraph 36 when it says, "The Commission's acknowledged in the past a level of efficiency and model for TSO purposes, not the maximum level of efficiency," and that really means static efficiency and ties back to the Cornerstone discussion. And then it goes on to say, as we've just seen, "The Commission recognise that the evolution of efficient network designs is restricted to some extent by past decisions." And it goes to say, "That's why we've taken the scorched node approach." On paragraph 37 it explains, "Some optimisation is necessary to maintain incentives for efficient investment." Then 38, it's rejecting arguments about using marginal cost for existing mobile networks to lower the costs.

BLANCHARD J:

Why wouldn't it take account of the mobile network that Telecom had decided to construct and had constructed, so it was there as an alternative means of supplying access to these customers?

MR HODDER:

Well, it wasn't quite at that stage. It had required some work. If I can ask the Court to turn to page 257, for example, of this document. This is a point that Arnold J made at paragraph 102 of his judgment, but at page 257, and we're in appendix 9 to this same determination, dealing with the wireless cap proposal and from paragraph 708 onwards, there's a discussion about areas of coverage, but at 710 and 711, point of the matter, what's proposed is to adapt the existing Vodafone GSM cellular mobile network, off Telecom's network, and then it goes on to say, "GSM networks used, but only for mobile telephony, are designed to deliver a performance which is inferior to that anticipated in the TSO."

So the point that Arnold J makes, and which we say is fairly made, is at this point the Commission's not saying that you can just switch to the mobile network, because there are quality issues tied with landline services which mobile services couldn't offer, but that it was capable of adaptation for that purpose.

ELIAS CJ:

It's that judgment that they revised later?

MR HODDER:

They, yes, in the 2004/5 –

ELIAS CJ:

Yes.

MR HODDER:

Well, I think what they're saying in this one is they think it's capable of it, if you adapt it.

ELIAS CJ:

Yes.

MR HODDER:

But it's not just there sitting as an overlay ready to use –

ELIAS CJ:

No.

MR HODDER:

– and they're blindly refusing to look at it. But then the costs of adaptation are a different exercise –

ELIAS CJ:

Yes.

MR HODDER:

– which requires a further major undertaking.

TIPPING J:

Would there also be an issue as to whether it was consistent with the scorched node approach?

MR HODDER:

Well, it's not, I'm assuming that if, that Blanchard J's question was to say, putting aside the scorched node approach, why don't they just use the mobile network that's there.

BLANCHARD J:

Yes, and you're really saying as at 2003/2004 it really wasn't there?

MR HODDER:

Yes. And there's a second point, which is there are also fixed costs associated with a mobile network which were never thought to be carried on in this process, and paragraph 38, back on page 116 where you were, is actually a response to some concerns expressed in Telecom's submissions, which, I might just give you the reference to it if I can find it quickly, volume 7, sorry.

BLANCHARD J:

Have we finished with page 257?

MR HODDER:

Yes, but not with 116. If I can just interpret this without, just briefly to finish off the answer to Blanchard J, if one can also look please at volume 7 at tab 83, and at page 3328, now this is a Telecom cross-submission on the revised draft determination, the last draft before the final 2003/4 determination. But at 3328 –

ELIAS CJ:

Sorry, this is not the submission that the, that is being referred to at 116 then?

MR HODDER:

Ah, it is a submission that is being responded to, effectively, at paragraph 38 on 116.

ELIAS CJ:

No, but it's not the, this is a later submission using the –

MR HODDER:

No.

ELIAS CJ:

– same argument is it?

MR HODDER:

No, this, this submission I am taking to you now –

ELIAS CJ:

Oh, is the one they're referring to?

MR HODDER:

Precedes what's being referred to at paragraph 38.

ELIAS CJ:

I see, thank you.

MR HODDER:

So paragraph 38 directly responds –

ELIAS CJ:

Yes I see.

MR HODDER:

– to the submission and so at paragraph 39 on page 3328, notes in the NSL is representing, I think they are representing Vodafone in this context, certainly not representing Telecom, so at 39 the Telecom submission notes that the other side observes their costs do not include any fixed or common costs associated with existing based stations and back haul. They note that mobile networks already exist and hence the only costs that should be allocated are the incremental costs of expanding the service to meet TSO needs. And then 40, in effect they are arguing that a new entrant's cost should be modelled on the assumption they can access existing site assets at incremental costs. Applied consistently, that would apply to Telecom's sunk fixed assets as well, that is, the cost of a new entrant would be modelled based on the assumption they could access existing fixed networks at incremental cost, rather than build their own fixed or mobile network.

Then goes on to say in paragraph 41, "If the Commission's aim were to estimate the lowest incremental cost, given the existence of current networks, then this will always involve modelling the continued use of the current network. In effect, this would mean providing zero return on all existing assets." This is clearly not the Commission's objective, we were saying nor is it the Act's objective. The Commission's objectives are, as they have been understood to date, "to model the cost of a new entrant who would have to earn a return on all capital required to provide this service, irrespective of whether that capital is already in existence." Then it goes on to deal with the real world issue, already supplied TSO service using a wire technology. "If the incremental costs of replacing the wire with wireless were lower than the incremental cost of continuing with the existing technology, then Telecom would already be using the wireless technology. This kind of decision is made regularly – for example for MAR sites."

Then at 43, "However, the Commission is not modelling the real world here. Instead the issue the Commission is addressing is the cost to provide the TSO service for a

new entrant coming to the market with the cheapest technology available in that year. This is a hypothetical construct. No-one suggests that in the real world Telecom would change technologies." So it's the submission to which this one is responding and this one which generates the Commission's paragraph 38, saying we're not interested in an argument which relies on economies of scale or low incremental costs derived from existing mobile networks because it doesn't provide incentive for further investment, it is treating them as – the existing assets as having a zero value.

BLANCHARD J:

What if they would have built them anyway because they were part of an overall mobile network that they were constructing? Has the Commission looked at that?

MR HODDER:

I don't know. Well, it's implicit in the discussion they've had, they were able to consider the general proposition, but in terms of the, I mean I don't know if one can avoid the history here, the history was that the quality required for these, for the TSO, were quality that were defined in terms of landlines and, as we saw back at page 7, whatever it was, there are issues around mobile technologies not getting the quality of service, there has to be some kind of adaptation –

BLANCHARD J:

In that year?

MR HODDER:

At least in that year, I don't know if –

BLANCHARD J:

What about later on?

MR HODDER:

I'm not aware where that's got to. I don't know that the technology's been modified or adapted.

BLANCHARD J:

Wouldn't it be part of the Commission's task to find that out?

MR HODDER:

Yes, it could be if it was going to continue to model it.

BLANCHARD J:

Was it not, was not a part –

MR HODDER:

Well that depends –

BLANCHARD J:

– of their task to look at that in the two later years that we're considering?

MR HODDER:

Well there's a different issue arises there, the Commission said, yes but we have to compensate for what that nets off so we're not going to do it. It's a different argument, the same point. We have to compensate to maintain the NPV=0 principal so rather than do that we just won't model. So they haven't done it for that reason, but recognising in the later decisions that at some stage they'll have to reinvestigate their whole model.

BLANCHARD J:

Well, we'll no doubt come back to that later.

MR HODDER:

We will be coming to the NPV=0 aspect, particularly in relation to the second appeal. So in terms of the 2003-4 determination, apart from those paragraphs we're looking on pages 115 and 116, the same point arises and is made in relation to depreciation, for example, at page 121 of the volume. You will see at the top of page 121 in paragraph 71, in the depreciation context, "... the primary concern of the Commission is to select a methodology which enables a TSP to recover the cost of prudent investment in providing the TSO, but no more than that amount... Investments in infrastructure... are mostly long-lived and irreversible. In order to allow the TSP to recover the cost of prudent investment, the TSP must have the expectation of recovering the costs of such investment over the period in which the assets can be usefully used to generate revenues". So I don't wish to labour the obvious, but the costs that have to be considered in the Part 3 context include the cost of capital. That means getting the capital back, otherwise you suffer a cost in getting a return on

it, that's a reasonable rate of return, and that ties back into the NPV=0 principle which we'll deal with more in relation to the second appeal.

Now, perhaps just finally, because of the interlink between efficiencies and cost – can I look at the 2004/5 determination, which is in volume 2 of the case on appeal at tab 25, and invite the Court to look at page 512 or 511 perhaps to start with. Now this is after the 03/04 determination that this first appeal is concerned with, but this is a more extended discussion of the efficiencies that we looked at included in the original Cornerstone paper and the Guide paper. So, starting at paragraph 41 on page 511, you'll see that at paragraph 42 the Commission is saying, we're looking at the meaning of "net cost" including the term "efficient service provider" in the context of both Part 3 and the general legislative context of the Act such as the purpose statement in section 18. Paragraph 43, "Any modelling... must reflect the cost of an efficient service provider. The reference to an "efficient service provider" principle does not in itself produce a single definitive approach that is free of controversy." And we say that goes to whether this is a question of law or not. And then 44 –

ELIAS CJ:

If they're right?

MR HODDER:

Sorry?

ELIAS CJ:

If they're right, that it doesn't produce a single definition.

MR HODDER:

I'm not sure even Vodafone claims it produces a single –

ELIAS CJ:

No I suppose that's right.

MR HODDER:

If they did I missed it, but I didn't understand them to be going that far.

In paragraph 44, "An efficient service provider could be defined as one who produces a given quantity... for the lowest possible cost", i.e., productive efficiency or static efficiency. "The desirable level of efficiency could also be referred – determined by

reference to a competitive or contestable market standard, where incentives operate... The Commission considers that imposing the highest standard of what is – effectively static efficiency possible – is unreasonable, particularly in the context of assessing the net costs of a social policy obligation". And then over the page at 512 we see again at paragraph 52 the three types of efficiency that we saw from the Guide, and a slightly extended discussion of each of those, that I particularly draw attention to 55 onwards. So at 55 talking of allocative efficiency, the Commission has considered allocative efficiency by using a long-run incremental cost methodology as a proxy for long-run marginal cost, but the increment's measured over the supply of the entire service. So it's equivalent to a long-run average of supply.

In 56, allocative efficiency is a less directly relevant consideration here. On productive efficiency at paragraph 58 the Commission says, "We've used the historical cost of Telecom only to a limited extent. The Commission has employed a formal optimisation technique using replacement cost to determine the asset base from which the normal rate of return on and of capital is calculated".

59, and that's a standard valuation method for regulated telecommunication services, and at 62 and 63 comes back to its theme, "It's unreasonable to impose a standard of efficiency that completely disregarded the costs that Telecom experiences and in doing so could, in itself, give rise to inefficiencies. While it is appropriate to depart from the actual historical costs faced by Telecom, the Commission considers that the TSO costing exercise should still have some regard to these costs. Other efficiency considerations are also important... If investments that appeared prudent at the time cannot be recovered because of inappropriately restrictive regulatory settings this could create a strong disincentive for any future investment by the efficient service provider". And then dynamic efficiency is again addressed in 64 through 66 and using the formula of NPV=0. It's the most efficient form of efficiency in practice as it relates to the ongoing investment and supply of services to end-users over the medium to long-term.

ELIAS CJ:

So why do you say – this is in 63 – that if the Vodafone proposal is adopted it would mean that the restrictive regulatory settings would create the disincentive?

MR HODDER:

As I understand it, if Vodafone is contending for scorched earth then every year you start again with no regard to the existing assets and the gap between the capital employed in the notional network and the capital employed in the real network becomes so great that there's – and with the trend downwards of efficiency in the notional network there's no recovery, and if you transfer that to an ex ante scenario there's no incentive to invest if you have to take that risk. Because you're not going to recover your capital.

ELIAS CJ:

It's material to your submission that this is the regulation of price effectively, isn't it?

MR HODDER:

It is, in respect it's hard to see how it could be otherwise when it's fixed by the Commission. So this is the, these couple of pages, in a sense, where the ties and the question of efficiency, efficient service provider, historical investments and dynamic efficiency come close to the heart of both this appeal and the next one insofar as they're then tied to this NPV=0 theory. The NPV=0 principle, in our submission, serves the purposes of all parties in a balanced way insofar as it says if you invest $100 million at the outset, or if you are deemed to have invested a $100 million at the outset, then you will get $100 million back at the end of the process, plus a reasonable return on capital. There's no windfall gain to anybody in this process because the cost, well unless you assume the costs are sunk and have no value, but the comparator is the competitive market where the capital cost is effectively related to the cost that would be faced by a new – building an optimal network.

And just to conclude on this, we've seen it before, but at 68 the Commission is confirming what it said earlier – where there are tensions between the different kinds of efficiency the Commission consistently takes the view that dynamic efficiency will generally better promote competition for the long-term benefit of end users. And as the Court knows, my argument is that's a perfectly legitimate economic approach to take, but the Court doesn't actually have to decide that, that's a matter for the Commission to decide. It doesn't involve a question of law, and it doesn't involve a question of law because nothing in this analysis that the Commission's undertaking is contrary to any specific provision in the Telecommunications Act.

TIPPING J:

Is this submission that within this complicated area, with these different types of efficiency, what weight you give to any one or other of them is a matter for the Commission?

MR HODDER:

Yes. Provided it stays in the bounds of rationality and reasonableness.

TIPPING J:

Yes.

MR HODDER:

Yes. Can I turn then to the Court of Appeal's judgment and address both the President's judgment and then go on – I'll deal, if I may, with the President's judgment and then Justice Winkelmann's judgment, and then come back to Justice Arnold's judgment, although I figure I've probably covered most of the points that Justice Arnold makes. So that's the Court of Appeal judgment, is volume 1 at tab 3. Now we've addressed the President's judgment in our written submissions and I wasn't going to spend a great deal of time on that, I just wanted to make two points in relation to this core issue about why not scorched earth. So at page 23, in paragraph 48 the President has as a sort of a platform point that, at least prior to 2003 and 4, the scorched node approach was right, or nothing wrong with it, and he says, so beginning in the second sentence of paragraph 48, "An efficient service provider will make long term investments in the infrastructure which are necessary to provide the required services. A system of modelling, which operates on the basis that those investment decisions are, in effect, up for grabs on an annual basis, would not make any sense." "On the other hand", he says, you can't regard scorched node as "implicitly embedded in the statutory scheme." And we don't contend that scorched node is embedded in the scheme, we say it's a matter of judgment for the Commission to decide, but what the President is recognising is that there is a time factor of a kind that I have been stressing in my submissions to the Court.

And it's perhaps significant that at the end of his judgment, in paragraph 57 on page 27, that the President upholds the Vodafone appeal on limited grounds, or would've upheld it on limited grounds, he says at 57, I recognise the complexities and address these judgments, address the reasons given by the Commission. "My approach comes down to the conclusion that Vodafone argument is more formidable that the Commission recognised. In this difficult area it would obviously neither be right nor

practical for a Court to come up with its own determination... I emphasise that I have not concluded that on such reconsideration the Commission would necessarily be required to adopt the Vodafone methodology." But if it's not required to adopt scorched earth, then what is the error of law? The opposition against me, as I understand it, is that if it is a matter of law, scorched earth would have to be adopted – not even the President says that. The President just says –

ELIAS CJ:

Well, he says they didn't do the exercise.

MR HODDER:

He says, "You didn't do the exercise properly", he doesn't say you must come under scorched earth. What he says is, "I don't think you considered mobile technology properly" and that's the argument. Now we say the argument on that is, doesn't stand up to the arguments advanced by the majority in relation to that, but insofar as the proposition is they must read the Act to mandate scorched earth because that's what's going to give you the least cost, then not even the President is saying that.

However, if I turn to Justice Winkelmann, I apprehend that she may be saying that. And so I'm – if I can move then to her judgment, we're talking here of the judgment at volume 1 tab 11, and if we could perhaps – sorry, if we could look at just a couple of paragraphs, as I say I'll be coming back to Her Honour's judgment in relation to the second appeal a little later, but can I start on page 376 of the case at paragraph 63, so Her Honour says, "Although the Act does not provide the Commission with a formula to calculate net cost as defined", and we agree with that, that's why we say it's a matter of judgment within balance, she goes on to say, "it does provide a framework". That, I think, is the same concept as the legal limits referred to by this Court in the *Unison Networks* judgment I'll come to later as well. Then each of the propositions she offers, with respect, has some problems with it. So firstly she says, "Telecom is to provide the Commission with its calculation of the net cost of complying with the TSO instrument".

ELIAS CJ:

Sorry where are you? What paragraph?

MR HODDER:

63, subparagraph 1.

ELIAS CJ:

Thank you.

MR HODDER:

Now, what needs to be understood there is it's providing its calculation of net cost in accordance with the Commission's requirements, and the Court will recall I took it to the letter from the Commission to Telecom saying, "When you send us your net cost calculations, you will use our model and our inputs, including our cost of capital". That point is not recognised anywhere, here or anywhere else in the judgment. And then in subparagraph 2, in its determination of the net cost, the Commission was taken into account that there was a reasonable return on the incremental capital employed by Telecom in providing the services. But it's not the capital employed by Telecom, it's the incremental capital calculated in accordance with the Act.

ELIAS CJ:

That an efficient provider would have to employ?

MR HODDER:

Yes, it's an ESP's capital, it's not Telecom's actual capital and with respect, that –

McGRATH J:

It's an interpretation of section 84(1)(b) this turns on, does it?

MR HODDER:

Yes. And if one looks at 84(1)(b), the matter to be taken into account is the provision of a reasonable return on the incremental capital employed in providing the services.

McGRATH J:

And Justice – this is where she later talks about "actually employed", I think, in relation to this, does she not?

MR HODDER:

I think so, she uses the phrase, "actual cost" or "actually employed" repeatedly throughout the judgment.

ELIAS CJ:

But this was a question I asked yesterday, because 84(1) in the top, refers to net cost, the defined terms, but in (b) seems to be referring to the incremental capital employed in providing the services to the customers, it doesn't seem to be, I wonder whether there is a difference between the ESP, the hypothetical, and the actual capital here?

MR HODDER:

With respect we say there can't be –

ELIAS CJ:

Yes.

MR HODDER:

Because (a) you're not calculating the actual capital employed by Telecom, what you're calculating is the capital that the ESP would be employing.

ELIAS CJ:

But it would have been possible for the Commissioner – this is the information that has to be provided to the Commission to do its calculation, isn't it?

MR HODDER:

Well, it's all purposes. It's in calculating the net cost under section 83 in preparing a draft under section 88 in determining the final net cost under 92, it applies to each stage.

ELIAS CJ:

Yes, but is it not possible that the scheme is that the provider does provide the Commission with its actual costs, and if the Commission had been doing a top-down calculation then that would've been necessary.

MR HODDER:

Yes, in that case you would then be dealing with the real network and real capital if you had a top-down approach.

TIPPING J:

And determining the net cost under section 92. The net cost –

MR HODDER:

Is an efficient service provider.

ELIAS CJ:

Yes.

TIPPING J:

You can have an efficient service provider, so paragraph (b) must be referring to an efficient service provider.

MR HODDER:

That's our argument.

ELIAS CJ:

Well, it may be however referring to the provision of the actual costs from which the Commission, applying top-down methodology, could arrive at an ESP net cost figure. Because on that methodology it would have to –

MR HODDER:

It certainly would encompass that if you used top-down.

ELIAS CJ:

Yes.

MR HODDER:

I mean, the original proposal by Telecom was to say, "Here, we've got a model which pretty much replicates what we do, and we think we're efficient with a, sort of a small margin, and so just use what we're giving you." The Commission goes through to some difficulty or to some pains to say, "No, we won't do that, we'll make our own model, which is a bottom-up model," which is described in all these various documents that are littered in the case on appeal. But if it had done a top-down, then 84(1)(b) would certainly cover the capital actually employed by Telecom, if that's the way we're looking at it. But it's also wide enough to capture the general concept of the ESP, and the only reason it would be applying to Telecom's actual capital was if it accepted that Telecom was an ESP. But as I –

ELIAS CJ:

But it's got to arrive at the capital that would be employed by an ESP, but that doesn't mean to say that the exercise that the TSP has to undertake first doesn't entail providing actual calculations.

MR HODDER:

Well, that rather depends on the Commission's requirements.

McGRATH J:

Might not the capital actually employed be relevant, even to an ESP-based figure?

MR HODDER:

Well, in one sense, perhaps, but the only reason you try and identify the capital is to figure out what the cost of it is, so you can give a return for it. And if you're not going to give a return based on Telecom's own capital, it's not much use to it, or anybody, in reviewing that. What you're interested in is the actual capital that you're attributing to the ESP, for which you're going to provide compensation.

ELIAS CJ:

It would have been easy for 84(1)(b) to have made it clear that it was a reference to a notional ESP, and it doesn't.

TIPPING J:

But that, with respect, that's what the section's all about. I mean, we may have a preliminary disagreement here, but it seems to me that if the whole exercise is to determine net cost, you have to bear in mind what net cost means, and if it means "to an ESP" then everything that follows must logically, unless the contrary is clearly indicated, be referable to an ESP.

MR HODDER:

That's our argument, and if Telecom is treated as an ESP –

ELIAS CJ:

But if top-down methodology had been adopted and was envisaged by the scheme of the Act –

MR HODDER:

Yes.

ELIAS CJ:

– and that is an issue that maybe does arise, then you would start with the actual costs and then you would discount it by the savings that you would expect an ESP to make.

MR HODDER:

Well, you'd discount the capital as well.

ELIAS CJ:

Yes.

MR HODDER:

So what you'd do is, you'd start with the proposition that Telecom is there or thereabouts as an ESP, it's not quite that, let's say it's, the regulatory decision is it's 10% inefficient. So you work out what its capital was, then knock off 10%, and so give it a return on 90% of its capital. So that way it would work with a top-down approach.

ELIAS CJ:

Mmm.

MR HODDER:

But you still, the end result is a reasonable return on the 90%.

ELIAS CJ:

Oh, yes, the end result, I totally accept, is the net cost as defined under the Act, which entails assessment as if it were an ESP.

MR HODDER:

Then I don't have any difficulty with that proposition.

TIPPING J:

Part of the problem is that this section as a whole is ducking between the abstract and the actual, and because (2)(b), for example, would seem to be actual.

MR HODDER:

Yes, in terms of revenues there's a greater focus on the actual. It is costs which are the hard one, because costs are by definition always going to be difficult to assess.

TIPPING J:

Oh, this legislation is…

BLANCHARD J:

I suppose it has to have an element of vagueness in it, because it's not prescribing the method of valuation –

MR HODDER:

Correct.

BLANCHARD J:

– and leaving that for the Commission.

MR HODDER:

That's our submission.

Now, I think I was at paragraph 63 of Justice Winkelmann's judgment, and we're looking at paragraph (ii) and, with respect, we say that that is a difficulty that she creates for her reasoning for the rest of the judgment. And in paragraph (iii) –

ELIAS CJ:

Well, she does acknowledge that the cost it calculates must be the unavoidable net incremental costs to an ESP.

MR HODDER:

In that case, it's difficult to understand why she's emphasised the words "employed by Telecom."

ELIAS CJ:

Well, it depends on what 84(1)(b) means.

MR HODDER:

Well, I accept that she says, that what she says in the last sentence comes closer to what we say the Act requires, but the use of italics in judgments is relatively rare, I am assuming it's of some significance and, with respect, the significance is misplaced.

McGRATH J:

So, Mr Hodder, just to make sure that this, as to the importance of this point, you really say the rest of the judgment largely turns on it, do you?

MR HODDER:

Yes, I do, I think there's a confusion, with respect, that arises with that judgment, because it isn't clear that she has not actually focused on Telecom's costs. So her concern, as the Court will know from reading her judgment, is that there's something fishy going on here because Telecom's actual costs are lower than it's getting from the return that the Commissioner's offering.

BLANCHARD J:

The point you're making, I suppose, is referable particularly to the second sentence of paragraph 68.

MR HODDER:

Yes, but it crops up in a whole series of places throughout this critical part of the judgment. I was going to ask the Court to look at paragraph –

McGRATH J:

And she – I think it's really the, comes back to the criticism Mr Gray's advancing, doesn't it? It's on this basis, she says, the Commission should have been paying attention to the historic nature of the costs.

MR HODDER:

Yes. And the answer to that of course is that when you're calculating costs there are various ways of doing it. If you choose not to use historical costs and you're using replacement costs going forward, because there is a cost of capital, then that becomes a somewhat irrelevant question, whether or not…

McGRATH J:

Yes.

TIPPING J:

At least we've got a nice clear point of law here, Mr Hodder.

McGRATH J:

Yes.

TIPPING J:

Something of a relief.

MR HODDER:

At this stage, the only other paragraph I was going to draw attention to was Her Honour's paragraph 75 on page 380, and it's the last part of that which is similar to paragraph 68, that Justice Blanchard drew attention to.

ELIAS CJ:

Paragraph…?

MR HODDER:

75, Ma'am. Now, there are some other points of criticism, but I'll leave those to the argument that comes a little later.

So, our point is in relation to those two judgments – I don't understand that it's possible to read the President's judgment as saying the law requires a scorched earth analysis, and if that is what Justice Winkelmann is saying, and it seems to be the logical corollary of what she's saying, then, with respect, we disagree and invite the Court to come to a different view.

McGRATH J:

Could you just give us your best part of this judgment for saying that's what she, her conclusion is, that she in the end comes down to favouring scorched earth. Because, I must, say, I hadn't seen that, I thought she was really just critical of the failure to apply the model as "statutorily defined", to use the phrase in 75.

MR HODDER:

What in effect I understand Her Honour to be doing is really dissenting from the majority in the Court of Appeal on this approach.

McGRATH J:

Yes.

MR HODDER:

She doesn't accept that, and the Court of Appeal majority is saying, "Scorched node is available to you because you have to take into account, or you're entitled to take into account, incentives for investment going forward." And she says, "No, I'm not accepting that. What I'm concerned about is that Telecom is being paid more than its actual costs." To avoid that, the answer would be a scorched earth approach.

McGRATH J:

Okay, so it's more your deduction as to the consequences of what she's saying, rather than any acknowledgment on her part, in this judgment, in Her Honour's part in this judgment?

MR HODDER:

Well, if we go back to paragraph 66, Your Honour, on page 377 I think it is, which is the point where she is implicitly clearly disagreeing with the majority of the Court of Appeal, where she says, "It seems unlikely the model developed by the Commission was ever well designed to function as a cap or check on the actual costs that Telecom was able to recover from other liable persons." Now, there really weren't that many choices between scorched earth and scorched node, and there she's clearly rejecting the scorched node. So yes, I am taking the inference from there and elsewhere that she is saying there should be a scorched earth approach.

McGRATH J:

Thank you.

ELIAS CJ:

Do you disagree with what's said later in that paragraph, I mean, I assume you do. "The model is tied to the configuration of Telecom's network as at 2001", it is isn't it?

MR HODDER:

Yes.

ELIAS CJ:

But you say if you adopt a dynamic approach, you have to – ?

MR HODDER:

Well it's certainly a legitimate option to the regulator to say, "If I wipe the slate clean under a scorched earth approach, then I will disincentivise investment and the dynamic efficiency will suffer."

ELIAS CJ:

And similarly the next sentence, "This means that new technology, even technology already used by Telecom... must be incorporated into the network in an artificial, possibly inefficient, way, thereby lessening its cost-reducing effect." That's true too?

MR HODDER:

That is true.

ELIAS CJ:

Yes.

MR HODDER:

And the Commissioner recognises it won't have the most ruthlessly efficient model, it says so explicitly –

ELIAS CJ:

Yes.

MR HODDER:

But it's doing that because it has to balance the efficiencies of new technology coming into the network with the efficiencies in new investment, which will be deterred ex ante if there was a loss of capital effectively guaranteed by the methodology.

ELIAS CJ:

But that's really what she says, is not complying with the section 5 definition.

MR HODDER:

It is, but it's also her criticism of the scorched node approach, because –

ELIAS CJ:

Yes.

MR HODDER:

And the scorched node approach says you would use something like MAR or possibly mobile technologies as an adjunct to the core network, when she's describing that she says, "That's artificial and possibly inefficient". Well it may be.

ELIAS CJ:

Which it is.

MR HODDER:

But if you're going to assume the core network then all that's left are adjuncts, and it doesn't give credit to the fact you're achieving efficiencies between the switch and the customer on the part you have scorched.

ELIAS CJ:

Where is the – don't take me to it, but where do I find the reasoning as to why the node was chosen as the limit of the application of new technology in the model?

MR HODDER:

I can't give you that immediately –

ELIAS CJ:

I mean there are a lot of conclusionary statements, but –

MR HODDER:

Why did they stop at the node?

ELIAS CJ:

Yes, I didn't seem much in the way of reasons provided for that.

MR HODDER:

I don't know that I can refer to it at this stage, I'll consider it if I may at the adjournment. I have nothing to give you to hand.

ELIAS CJ:

That's fine. It may be there isn't anything, but if there is, I'd like to have a look at it.

MR HODDER:

I'm sorry, my assumption at this stage is that that is a technology or a methodology adopted from elsewhere.

ELIAS CJ:

Yes, I think they make that reference.

MR HODDER:

That's the assumption.

ELIAS CJ:

The trouble is one doesn't know whether it's in the same sort of context at all. Anyway, thank you.

MR HODDER:

Now, I was thinking about going through Justice Arnold's judgment, but in effect I think we've covered most of the points Justice Arnold makes, but I'm happy to go through it if the Court thinks it would be useful.

McGRATH J:

I would like you to perhaps go through quickly, but I'd certainly like to look at what he's saying in context.

MR HODDER:

In that case, can I start with his paragraph 91, so we're back at tab 3 of volume 1 of the case on appeal, and in my – it may be useful to start at page 40, which is where paragraph 91 is and he notes, "The argument before us is there is no direct challenge to the Commissioner's decision to adopt a scorched node methodology, although as I say below I consider that Vodafone's approach is inconsistent with it. As I see it the methodology has much to commend it. The scorched earth approach

may be economically pure, but it's doubtful that it is realistic, given that it would not allow TSO service providers to recover the costs of investments that were efficient when made, an an important consideration in telecommunications which is characterised by large capital investments and rapid technological change. In my view, the Act, like the Commerce Act, is not concerned with the abstract economic theory, but with the application of economic concepts and principles in the real world setting. It establishes a regulatory regime which incorporates economic principles, but is based on the reality of New Zealand telecommunications markets." And I'm surprised that we endorse that, and invite this Court to endorse that as a proposition.

And then 92, "The Commission's decision to adopt a bottom-up model incorporating a scorched node approach reflects the Commissioner's assessment of the appropriate balance to be struck between the various interests at play. A top-down approach would have started with Telecom's actual costs and modified those... The Commission considered this insufficiently rigorous and chose a bottom-up, scorched node approach, which it considered created stronger incentives for efficiency. But it also recognised that to assume a TSP could 'wipe the slate clean' each year... would run the risk of under-compensating the TSP for investments that were efficiently incurred." That clearly is echoing precisely what the Commission has done, and its thinking about these matters to date.

ELIAS CJ:

And the backward-looking approach that's adopted and endorsed here, you say on the statute, is derived from section 18. There's nothing else, is there?

MR HODDER:

And the concept of the efficient service provider. The efficient service provider will make efficient decisions over time. So if it makes an efficient decision in year one, there's not an inefficient decision in year five, they'd still be acting as an ESP when it's providing services over a period that extends beyond one year.

TIPPING J:

You've got to give it such respect as the new circumstances allow or suggest –

MR HODDER:

Yes.

TIPPING J:

You can't simply say, we'll forget, because otherwise people won't invest.

MR HODDER:

Well, the assumption I suppose I should make explicit a premise is that your notional ESP has a continuing existence, you don't hypothesise a new ESP every year. And so it's not a sort of a perfect ESP, it may with the benefit of hindsight prove to have made a decision that wasn't efficient with the benefit only of hindsight, but it was efficient at the time it was made, you don't deem it to be an inefficient ESP in the subsequent years and so it's the timing factor that becomes critical again.

ELIAS CJ:

But it's a timing factor in the context of the telecommunications industry which has a very high risk of technological stranding.

MR HODDER:

Yes, well that – I mean partly we come to that, we go with tilted annuities.

ELIAS CJ:

That is factored in, you say?

MR HODDER:

Yes.

ELIAS CJ:

Yes.

MR HODDER:

So, that's all perfectly understandable, and that comes into the depreciation regime. If you note –

ELIAS CJ:

That comes in in favour of the TSP in the depreciation regime in its application.

MR HODDER:

Well the favour just simply helps the TSP recover its capital.

ELIAS CJ:

Helps it.

MR HODDER:

So if you have rapid change then you depreciate your assets over three years rather than 20 years.

ELIAS CJ:

Yes, I'm just wondering about the combination of the two, the – I would've thought that the depreciation regime is where you recognise the technological risk in this industry, rather than in the –

MR HODDER:

Well it crops up at various points. One is the depreciation regime, one – there's an argument about this, but one may be in the asset beta area –

ELIAS CJ:

Yes.

MR HODDER:

Then there's the question of the valuation of the assets themselves.

ELIAS CJ:

They're all going one way?

MR HODDER:

Well, all they're doing is trying to recover the cost of capital, the cost of capital means you must get your capital back and you get a reasonable return on it. But one point that I should have perhaps made in discussing Justice Winkelmann, she has little to say about dynamic efficiency, and seems to assume that if you have technology that is new technology that will push the price down, but that doesn't have regard – and I'll deal with this later on in more detail – doesn't have regard to the depreciation factor. If you're going to write your assets off over three years, then you'll be recovering at high prices down the stream in those three years than if you're writing over it for 20 years. So if the consequence is to say, "We want to reduce the costs" you don't do it by being more brutal, in a rational system that will just push up the price through the return of capital. Anyway, I'll come to that in more detail when we spend more time in tilted annuities.

If it's convenient, I was going to turn next to page 48 of the case, where Justice Arnold has at paragraph 111, and following – and this again is coming back to the scorched aspect of it. Counsel for Telecom submitted that Vodafone's approach to mobile technology result in the scorching of part of Telecom's core network, contrary to the premise underlining this Court's node model, that's why the Commission rejected it. Justice McGechan in the High Court accepts that. I agree, and with respect I'm not sure that's really in dispute. Well, subject to the question about using it as an overlay, but to the extent that you're using and making redundant assets, then you are in effect scorching, by making redundant part of the core network which has been defined for the purposes of the model. And then paragraph 112 identifies the contradiction, and then His Honour goes on to discuss the President's approach in paragraph 113, and concludes by saying the President's approach implies that the Commission should have been willing to apply a scorched earth methodology. And then 114, explains his reasons for saying I don't accept that the Commission has simply applied its scorched earth model, rather scorched node model, rather than applying the statutory tests, nor do I agree that it should have applied a scorched earth methodology. And those, that sentence sort of captures the major issue for this Court on this appeal. The – if the Judgment of Justice Arnold is correct and his conclusions are correct then, as we say they are, then that pretty determines the appeal. And then what he does in the rest of that is to go on and articulate the points I have been making and talking about the balance of considerations that the Commission is entitled to have regard to.

And then at paragraph 124, well perhaps I can just pause at –

TIPPING J:

Could I just have a little bit of help – where Justice Arnold says in the middle of 114, "But I do not think it reasonable to expect that the Commission should, on the first occasion that mobile phone technology was capable of meeting the quality standards" –

MR HODDER:

Yes.

TIPPING J:

I thought you said that it wasn't the point we're concerned with, at least in one of these appeals?

MR HODDER:

Can I invite Your Honour to look at page 44 for a moment, please, at paragraph 102?

TIPPING J:

It's just a matter of clarification probably.

MR HODDER:

Yes I think there's clarifications at paragraph 102.

TIPPING J:

Good.

MR HODDER:

So he says, "It's important to understand the basis on which the Commission introduced the MT cap. The Commission accepted that mobile technology was *technically* capable of meeting the standards", and he emphasises those words. "This is not the same as saying that the service that would have been provided to CNVCs from an existing mobile network (unadapted) would have met those standards". Then he refers to the paragraph I took the Court to a few minutes ago, at paragraph –

TIPPING J:

I see, that's fine, thank you –

MR HODDER:

And then he carries on –

TIPPING J:

– I'll just make a note to refer back to 102.

MR HODDER:

Yes.

ELIAS CJ:

Just because we're on the page –

MR HODDER:

Which page, Ma'am?

ELIAS CJ:

Sorry, page 44, but looking over at page 45, the quote from the Commission's determination at para 40 –

MR HODDER:

Yes.

ELIAS CJ:

– did you take us to that paragraph?

MR HODDER:

Yes, that's the one just after the one where they talk about marginal cost not being acceptable.

ELIAS CJ:

Yes.

MR HODDER:

It's in volume 1 of the case on appeal, at page 115, 116.

ELIAS CJ:

Right.

MR HODDER:

And there's a group of paragraphs, I focused on paragraph 38.

ELIAS CJ:

How does that approach that it will accept the lowest cost technology consistent with the scorched node approach, how does that fit the definition of net cost? I mean that's really what the President is saying.

MR HODDER:

Well, it's deeming that to be consistent with what an efficient service provider would do, and to some extent it's taking over the efficient service provider persona but to try and get to what an efficient service provider would do, which is the criteria it's applying including an efficient service provider –

ELIAS CJ:

Yes, it's just saying that the scorched node approach is – parallels what the Commission expects of an efficient service provider?

MR HODDER:

Possibly better to say it's the best proxy that can be constructed.

ELIAS CJ:

A best proxy, yes I see.

MR HODDER:

And so it's consistent with that proxy that in the adjunct areas you use the lowest cost technology, that's what it was saying in 2003-4, but maintaining the integrity of the scorched node approach.

So if it was convenient I was going to then touch briefly, I think, on paragraph 124. No I was going to – yesterday we talked briefly about unavoidable and incremental, more than briefly, which is addressed by His Honour at paragraph 120 on page 51, and just in that connection I've given, I hope, to the Registrar a page of blue which I was just going to hand up to you, which was the reference that His Honour gives on the next page on page, on page 52 from the original local access High Court judgment.

ELIAS CJ:

Sorry, what's this?

MR HODDER:

So, at paragraph 120, Justice Arnold is saying –

ELIAS CJ:

Oh yes.

MR HODDER:

– "We understand incremental, I don't know what unavoidable adds to it," and he then cites at the end of that paragraph from this particular Judgment, which is the High Court decision of Justice Ellis and Professor Brunt in the original local access dispute between *Clear v Telecom*, the one that finished up going to the Privy Council, and we all finished up with the joys of counterfactuals. But on this page, 1 – 202, if one comes down to the fifth paragraph beginning "marginal cost" one sees, "Marginal cost as a cost of producing one additional unit of product or service, it is also called incremental cost, it is calculated by forward-looking analysis of cost, so historical costs, for example, applying to equipment are irrelevant. The acceptance so far is they've been used as a guide to future cost. Incremental cost also includes the replacement cost of capital items and a competitive return on the capital invested". That is the present worth of the assets being used, not the cost of them or whether that again may be a guide. The competitive return reflects market conditions and a risk.

Now, one might speculate that has more of the hand of Professor Brunt in it, but what I am really pointing out is that this is an acceptance in the Courts that that is a relatively respectable understanding of incremental cost. And Justice Arnold's point is, and there's no answer then given by anybody else that unavoidable doesn't tell us anything very much, and you can understand that unavoidable is also incorporated in the concept of incremental.

So 124, sorry –

ELIAS CJ:

This approach says that it's a forward-looking analysis and historical costs are only a guide to future cost.

MR HODDER:

And that's what the Commission does in this case. It doesn't use Telecom's historical costs, it uses historical network configuration –

ELIAS CJ:

Yes.

MR HODDER:

– but not its costs. It substitutes optimised costs.

ELIAS CJ:

Yes.

MR HODDER:

At 124 on page 53, His Honour, again it's accepting the Commission was applying a balancing exercise and so concludes that the touchstone was not the lowest possible cost but the lowest possible cost consistent with the other factors to which the Commission is entitled to give weight, that is the touchstone was of the maximum level of efficiency by reasonable standards of efficiency, and that's our general point about Part 3 relevancies which the Commission was entitled to have regard to.

I am skipping over the various parts of the judgment, but at 132 he identifies the dispute, without using the language perhaps I have been using, but what he's really doing is discussing the difference between using mobile technology as an adjunct and using mobile technology because it overlays the existing fixed network. So the Commission says we'll use it, it could be used on other technologies, might be used as an adjunct to the – from the nodes, but the Commission – and Vodafone are saying it's on the mobile network as a whole in its overlaid existence.

And at 133, His Honour's point is that the Act, including section 18, doesn't give any clear answers to any of this, and we say that's right. And at the top of the next page under 133B, he explains one of the reasons why that might be so, which reinforces our point that this is not a question of law, what is required for the promotion of competition in telecommunications markets for the long-term benefit of end-users and the achievement of efficiencies is not self-evident. It's debateable, it requires consideration in the range of sometimes competing factors and it requires an evaluative assessment. And so what he says at 136, in the end having – the Commission did have regard to section 18, what it did do was give greater weight to some facets of the competition/efficiency analysis in other – that's precisely what specialist bodies are supposed to, such as the Commission, are expected to do.

Now that concludes what I wanted to say about the first appeal, except for taking the Court briefly to *South Yorkshire*, which is the – and I see we're at the adjournment stage, that is the case which I say provides authority for in effect what Justice Arnold is saying, that where a decision-maker has a range of possibly competing

considerations and has to form a judgment, there will be cases where the language isn't amenable to a single definitive, judicial exposition.

ELIAS CJ:

Thank you, all right, we'll take the adjournment now.

COURT ADJOURNS: 11.30 AM
COURT RESUMES: 11.53 AM

MR HODDER:

If it please the Court, could I touch on the question of sitting, which you raised with us earlier?

ELIAS CJ:

Oh, yes.

MR HODDER:

We've had a discussion among counsel, and we do not wish of course to impede the arrangements that Your Honour the Chief Justice is to take to take tomorrow, and obviously we acknowledge Justice Blanchard's engagement as well. We think that extended hours, that may get there. The original estimate of four days was, we think, reasonable, but if we were to sit longer hours on the other days, if the Court can accommodate that, we think we would have a reasonable chance of getting to the end of it.

BLANCHARD J:

Sorry, which other days?

MR HODDER:

Well, we suggested we started at nine tomorrow rather than 10, and then on Thursday again, sitting at nine, and we may have to sit beyond four. This –

ELIAS CJ:

All right, well –

TIPPING J:

I can't sit beyond four on Thursday, it would be very difficult.

ELIAS CJ:

All right, well, we'll consider that and let you know. I think if there's any risk we should just carry on. So –

MR HODDER:

Well, we're reluctant to –

ELIAS CJ:

– perhaps we'll do that.

MR HODDER:

Well, we are truly reluctant to have that, given the circumstances. On the other hand, this is a matter which is of some complexity and it's difficult –

ELIAS CJ:

And we don't want to, we certainly don't want to break the hearing. So we'll discuss it and let you know after lunch. But I'm very grateful to counsel for that indication and for trying.

MR HODDER:

Well, can I just say one further point in relation, Your Honours, that's the question of a break in the argument, would it be a matter for the Court, counsel would accept that if that had to happen it had to happen, so…

ELIAS CJ:

No, I think we will not do that, but thank you.

MR HODDER:

Just one matter before I turn to *South Yorkshire.* Her Honour the Chief Justice asked me about whether there was any reason why one stopped for the node. The answer's not particularly informative, but can I just give you the best I can. One goes back to the Cornerstone paper, which is in volume 2 of the case at tab 30, and to page 969. And at page 969 we have the heading, "Scorched node or scorched earth," and we've seen this page before. And at paragraph 160 the scorched node alternative is introduced in the first sentence, and then in the second sentence it

says, “Typically this includes the nodes such as network switches and points of interconnection.” So the question –

ELIAS CJ:

Yes, I queried the “typically” with Mr Gray, I think.

MR HODDER:

All we can do is note the footnote. The whole section appears, by footnote 4, to draw on the document that's at tab 28 in the same volume, and in that context we’re talking again about the report done by the University of Auckland’s Centre for Research and Network Economics for the MED, and at page 851 in paragraph 16 the authors say that “The approach to the problems considered here is based upon our experience with similar problems in other jurisdictions,” which introduces the idea that I think I gave an interim answer to the Chief Justice. And then at 858, is where –

McGRATH J:

So what paragraph at 851 was that?

MR HODDER:

16, Sir. And then on –

BLANCHARD J:

Do we know what jurisdictions they’re referring to?

MR HODDER:

If one goes to the references at pages 50 to 51…

ELIAS CJ:

I do admire –

MR HODDER:

Sorry –

ELIAS CJ:

– your knowledge of this material.

MR HODDER:

Sorry, 895 to 896, there is simply – all I can do by way of answer to Justice Blanchard is say the matters that are referred to there include ACCC Australian matters, and I think there's some American material in there as well. So all I can say is I think it draws on Australian and the North American material. The only other paragraph that I was going to draw attention to in this document is that at page 858, is where there is the actually discussion of scorched node in this document, and again it's framed in general terms, for example at paragraph 44 it says, "The basic principles of optimisation are quite well understood," and in 45 it says, "Some optimisation models are based on scorched node," and then we find that word "typically" again, which we also found in the Commission's Cornerstones paper. Now, beyond that I don't think I can assist the Court from the bundle.

ELIAS CJ:

Thank you.

MR HODDER:

This may be slightly radical, but can I turn to our written synopsis in relation to this appeal?

ELIAS CJ:

It might be hard to find…

MR HODDER:

Dated 12 November, called, "Written submissions of opposition to appeal SC 04/2010, network mobile modelling issue." It's not essential, but I was going to say that actually there is some reference between what I am saying and what's in these submissions and, particularly on this point, it arises from pages 11 onwards in relation to the jurisprudence.

McGRATH J:

The needle in the haystack…

MR HODDER:

Indeed, Sir. So, our proposition, as the Court knows, is that it is legitimate for the Courts to say, in relation to some statutory language, "It is not amenable to a definitive interpretation such that any departure from it would be an error of law." And the principal authority we rely on for that is at tab 11 of our second

bundle of authorities, which is a thinner bundle. The bundle is dated 12 November 2010, if that helps.

McGRATH J:

Is it your bundle of authorities, you say?

MR HODDER:

We have, yes, we have two bundles. This is the smaller one, Sir.

TIPPING J:

And it's tab 11 in that bundle?

MR HODDER:

Correct, *R v Monopolies & Mergers Commission, ex parte South Yorkshire Transport.*

TIPPING J:

Monopolies Commission, yes.

MR HODDER:

So, the question was whether or not, for the purposes of the British Fair Trading legislation and various merger references, a particular part of the United Kingdom in *South Yorkshire* was a substantial part of the United Kingdom, that's the statutory phrase, "a substantial part of the United Kingdom," and so the question was whether as a matter of law there'd been an error in relation to that statutory language. In the leading speech, with which the others agree, is given by Lord Mustill, and there are a couple of points in his judgment which I would draw to the Court's attention.

At page 29 we have introduction to a phrase that crops up a couple of times, being "spurious degree of precision", but this comes at the top of page 29, His Lordship says, "Approaching the first stage is a matter of common language, and no recourse need be made to dictionaries to establish that "substantial" accommodates a wide range of meanings. At one extreme there is "not trifling", at the other there is "nearly complete. The protean nature of the word has been reflected in the decided cases, made quite clear in the judgment of Justice Otten. Sufficient to say that although I do not accept that "substantial" can never mean more than "de minimis", Viscount Simonds was saying "more than that," and would look at the statutory context, I am satisfied that the word does indeed lie further up the spectrum. To say

how far up is another matter. The Courts have repeatedly warned against the dangers of taking an inherently imprecise word and, by redefining it, thrusting on it a spurious degree of precision." Now, that phrase has attracted the attention of subsequent courts and has been used by them as well.

The relevant part that follows next is at the bottom of page 31, where at about, just above the H marginal note, His Lordship says, "I readily accept the Commission can and indeed should take into account the relative proportions of the area by comparison to the United Kingdom as a whole as regards surface area, population, economic activities and, it may be in some cases, other factors as well, when reaching a conclusion on jurisdiction. Neither each of them on its own nor all of them together can lead directly to the answer. The parties could reasonably expect that since the test, which the respondents contend has been rejected, another would be reposed in its place," and then there an implied "but", "I am reluctant to go far in this direction because it would substitute non-statutory words for the words, 'of the Act,' which the Commission as a Commission is obliged to apply, and partly because it is impossible to frame a definition which would not unduly fetter the judgment of the Commission in some future situation not now foreseen." Then he addresses the matter in a different way further down on page 32, at just below marginal note D he says, "The respondents say that the two stages of the Commission's inquiry involved wholly different tasks. Once the Commission reached the stage of deciding on public interest and remedies and was exercising a broad judgment, his outcome could be overturned only on the ground of irrationality," again, an implied "but". "The question of jurisdiction, by contrast, is a hard-edged question, there was no room for legitimate disagreement. You, the Commission, had jurisdiction or would have not. The fact that it's quite hard to discover the meaning of section 64(3) makes no difference. It does have a correct meaning and one meaning alone, and once this is ascertained the correct application of the facts of the case will always give the same answer. If the Commission has reached a different answer it's wrong, and the Court can and must interfere."

Now remember, the statutory language we're talking about is "a substantial part of the United Kingdom". So this is the orthodox proposition: it's statutory language, there must be a right answer, if the Commission hasn't used that answer it's wrong in law. That's really the argument we're hearing, apart from Vodafone. What Lord Mustill then says is, "I agree with this argument in part, but only in part. Once the criterion for a judgment has been properly understood, the fact that it's formally part

of a range of possible criteria, it becomes a matter of history, the judgment now proceeds unequivocally on the basis of the criterion as ascertained." So far, no room for controversy, now an explicit "but": "But this clear-cut approach cannot be applied to every case, for the criterion so established may itself be so imprecise that different decision-makers, each acting rationally, might reach different conclusions when applying it to the facts of a given case. In such a case, the Court is entitled to substitute its own opinion for the other person's to whom the decision has been entrusted only if the decision is so aberrant that it cannot be classed as rational," and they cite *Edwards v Bairstow.* "The present is such a case. Even after eliminating inappropriate senses of "substantial", one is still left with a meaning broad enough to call for the exercise of judgement rather than an exact quantitative measurement. Approaching the matter in this light, I am quite satisfied there was no ground for interference by the Court, the conclusion at which the Commissioners arrived was well within permissible field of judgement," and then it goes on to add, obiter effectively, that I would say it was right.

Now, that approach has been adopted, and we've included in our submissions a table or a schedule, at page 25, which sets out various other cases where we've set out the case, the phrase in question, the relevant discussion –

ELIAS CJ:

Sorry, where do you have this?

MR HODDER:

This is in –

ELIAS CJ:

Oh, in your submissions.

MR HODDER:

– our written submissions.

ELIAS CJ:

Yes, that's right.

MR HODDER:

From page 25.

ELIAS CJ:

Yes.

MR HODDER:

There are a series of cases there, which I don't propose to go through.

ELIAS CJ:

You haven't got any of the criminal ones, *Brutus v Cozens* and…

MR HODDER:

Well, I was about to come to *Brutus v Cozens* in a slightly indirect way, if I could. Just to pick up the way in which it's dealt with in a perhaps typical way by Lord Hoffman, if we get to the case of *Moyna v Secretary of State for Work and Pensions* [2003] 1 WLR 1929 (HL), which is at tab 5, at least I think that's where he deals with it, among other places. Yes, he does. We get to it. Picking up the judgment, which is at tab 5, perhaps first on page 1933 at paragraph 17, the criteria that the statutory authority had to determine here was, "cannot prepare a cooked main meal." Now it's a slightly different context to "net cost" of an efficient service provider but, again, the point is that the language is not amenable to particularly precise elucidation. So, that's the criteria that the statute imposed, "cannot prepare a cooked main meal,"…

TIPPING J:

This is for a disability –

MR HODDER:

Yes.

TIPPING J:

– sort of case, is it?

MR HODDER:

Disability living allowance.

TIPPING J:

Right.

MR HODDER:

And the level of severity of the disability. So, paragraph 17, His Lordship says, "There are two points to be made about the 'cooking test'... The first is that its purpose is not to ascertain whether the applicant can survive, or enjoy a reasonable diet, without assistance. It is a notional test, a thought-experiment, to calibrate the severity of the disability," and that idea of a notional test and thought-experiment is, I think perhaps, or I submit it's perhaps, of some assistance in this context. And then later in he says, "That leads on to the second point, which is that the test says nothing about how often the person should be able to cook," and so on and so forth. But his point is there that it doesn't give any precision in the test itself. And so then it takes him to 19, where he says, "I therefore agree with the commissioner that the question involves taking 'a broad view of the matter' and making a judgment. The standard of motor abilities required by the cooking test is not so precise as to allow calibration by arithmetical formula," and then he goes on in paragraph 20, "In any case in which a tribunal has to apply a standard with a greater or lesser degree of imprecision and to take a number of factors into account, there are bound to be cases in which it would be impossible for a reviewing court to say the tribunal must have erred in law in deciding the case either way... I respectfully think it was unrealistic of Kay LJ to think he was able to sharpen the test to produce only one right answer. In my opinion the Commission was right to say that whether or not he would have arrived at the same conclusion, the decision of the tribunal disclosed no error of law." And then he goes on to discuss *Cozens v Brutus,* to which the Chief Justice referred, and he cites from it at paragraph 22, discusses what Lord Reid is saying, and at paragraph 25 says, "Lord Reid's second point" is made in the last sentence of the passage he's quoted from, that is it's –

BLANCHARD J:

What was the second point?

MR HODDER:

The second point is the one that's at the very end of the quote in paragraph 22, the last sentence. Lord Reid says, "It is for the tribunal which decides the case to consider, not as law but as fact, whether in the whole circumstances the words of the statute do or do not as a matter of ordinary usage... apply." So that last sentence from Lord Reid is what is then picked up at paragraph 25 by Lord Hoffman, this point's made in the last sentence, "The question of whether the facts found by the

tribunal count as 'insulting'... is a question of fact. There is a good deal of high authority for saying that the question of whether the facts as found or admitted fall one side or the other of some conceptual line drawn by the law is a question of fact" and cites *Edwards v Bairstow.* What this means in practice is that an appellate court with jurisdiction of entertaining people only on questions of law, will not hear an appeal against such a decision unless it falls outside the bounds of reasonable judgment.

Then he cites, or goes on, it may seem rather odd to say that something is a question of fact when there's no dispute whatsoever over the facts, and the question is whether they fall within some legal category, and he cites Lord Devlin's *Trial by Jury*. Then, 27, "Likewise it may be said that there are two kinds of questions of fact: there are questions of fact; and there are questions of law as to which lawyers have decided it would be expedient for an appellate tribunal to have to form an independent judgment. But the usage is well established and causes no difficulty as long as it is understood that the degree to which an appellate court will be willing to substitute its own judgment... will vary with the nature of the question." And so we say that Vodafone's appeal is in fact a question of fact.

ELIAS CJ:

Which word are you saying is only capable of a factual answer?

MR HODDER:

The entire phrase of applying the net cost of the efficient service provider.

ELIAS CJ:

So efficiency is a question of fact?

MR HODDER:

The phrase, is involved, and requires an answer by a clarification of fact.

ELIAS CJ:

Well, you know, generally in statutory interpretation we start with the Interpretation Act, which does require us to look at context as well, and so I think perhaps you have sufficiently taken us through the context of the Act but –

MR HODDER:

I'm sorry, but I see the context makes it worse.

ELIAS CJ:

Yes.

MR HODDER:

So the context is the rest of Part 3.

ELIAS CJ:

No, I understand that, yes.

MR HODDER:

Yes. So we say that when you have, when one is considering the language of Part 3, whether it's the definition of net cost with its reference to section 18, or the tasks set out in section 92, the criteria are sufficiently imprecise that it cannot be given a single answer, and the authorities I'm referring to are consistent with that. And as we apprehend it that's not inconsistent with the law as discussed, not by reference to *South Yorkshire* in New Zealand, in our written submissions we note that in *Bulk Gas Users Group v Attorney-General* [1983] NZLR 129 (CA) the Court of Appeal seemed to leave room for that. We refer to that at paragraph 315 of the written submissions, *Bulk Gas* is in this bundle, but I wasn't proposing to go there, the relevant phrase is reference to a "definite or ascertainable test", as opposed to matters of judgment, and then in this Court's decision in *Unison*, the same idea is in the judgment that His Honour Justice McGrath gave for the Court, it may be worth going there for a moment, that's at tab 15 of our bundle. So the case, as most members of the Court will recall, was in relation to the power of the Commerce Commission to effectively impose or declare price controls in relation to a network enterprise.

But for my purposes, what I'm focussed on is the general approach, which is recorded in the judgment of the Court, so at paragraph 54 and 55, at page 58, the Court was talking about the purpose, this was the judicial review case, I understand the challenge extended to error of law, "Ascertaining the purpose for which a power is given is an exercise in statutory interpretation which is not always straightforward. This is partly because legislative regimes differ in specificity with which they grant powers. In this area the Courts are concerned with identifying the legal limits of the power rather than assessing the merits of its exercise in any case, they must be careful to avoid crossing the line between those concepts," and with respect we say

that's effectively what this appeal seeks to do, is to overcome the line. "Often, as in this case, a public body with expertise in the subject-matter is given a broadly expressed power that is designed to achieve economic objectives which are themselves expansively expressed. In such circumstances Parliament generally contemplates that wide policy considerations will be taken into account in the exercise of the expert body's powers. The Courts in those circumstances are unlikely to intervene unless the body exercising the power has acted in bad faith, has materially misapplied the law, or has exercised the power in a way which cannot rationally be regarded as coming within the statutory purpose." Now obviously we will say that that paragraph is consistent with what's said in both *South Yorkshire* and in *Moyna*. And then, perhaps, the only other point I should make there is just a note that the Telecommunications Act is to some extent an adjunct to the Commerce Act.

The Court will recall that the Telecommunications Commissioner and two other Commissioners in the Commerce Commission form the Commission for the purposes of the Act, and a number of provisions are just imported directly from the Commerce Act into the Telecommunications Act. So the very reference to "expert body with expertise in economic matters" is why it's the Commerce Commission making these decisions rather than some other tribunal or decision-maker.

At paragraph 64 in *Unison* it is said that "the most important consideration in ascertaining the limits on the threshold setting power is that the section is broadly worded. It's more broadly worded than the power to impose control. As well, the Act is not explicitly stipulating any necessary attributes or thresholds – of thresholds other than to say that thresholds can be expressed in quantitative or qualitative terms. The power is designed to achieve broad economic objectives, and it is given to a body with expertise in the field." And we say there, and the same thing's applicable here.

Now, moving on to page 63 in paragraph 74, where the error of law point is dealt with, "The second ground of Unison's appeal is that the Commission misconstrued the requirements of the legislation and applied the wrong legal test..." 75, "Any material error of law by a public body in exercising its statutory powers will be reviewed by the courts". And the footnote refers to *Bulk Gas*, but then at 76, "It will be apparent that the argument on this ground overlaps with that already considered as to the failure to exercise powers for the statutory purpose." And then at the end of the paragraph, "The statute contemplates that the Commissioner, as a specialist

body, will exercise judgment in constructing thresholds which will contribute to the administration of the targeted control regime." And 77 says, "The requirement that it set thresholds could have been lawfully tackled by the Commission in one of two ways." Now, obviously that's dealing with its own particular statutory context, but we say that context is not too dissimilar to the one that we are now concerned with on this appeal.

So, if the Court pleases, if there's nothing, perhaps the only other point to mention, without going there, is that we include in our bundle, at tab 18, an extract from H W R Wade and C F Forsyth, *Administrative Law* (10th ed, Oxford University Press, Oxford, 2009) which treats *South Yorkshire* as not being some aberrant decision, but as being mainstream and also – yes, it cites a number of the other cases, which are also in this volume, in case that's of relevance, but subject to the fact that I am relying of course on the written submissions without going any further to them, that was what I was planning to say on the first appeal.

ELIAS CJ:

Thank you.

MR HODDER:

The bad news is that there are two to go.

ELIAS CJ:

Yes.

MR HODDER:

Can I turn then to the appeal that relates to Justice Winkelmann's judgment on the new technologies judgment. There are a number of matters here which overlap, well, the factors I've been addressing so far, and I'm hopeful that will enable us to move more quickly. The essence of the complaint is that the High Court has wrongly interfered with the Commission's decision, following the logic of its scorched node methodology and its NPV=O principle, to say that as it has a choice between either making further allowances for the risk of stranding, which it hadn't made earlier, or allowing modelling of mobile technology which would set each other off, the pragmatic thing to do is not to model the mobile technology and also not to make any compensation for the fact it was concerned about. As they netted of, it decided it wouldn't model further new technologies. That was – we say the same principle

applies as I've just been discussing – that was a matter of judgment for the Commission to make, it had choices to make, and it made them and there was nothing obviously irrational about what it did, or nothing inconsistent about what it did. And we say that the fact that the High Court intervened and said that was an error of law was itself an error, because it wasn't an error of law for the reasons I've been going through. That's the overview.

To explain a little more why that was a legitimate choice for the Commission, I would ask the Court, or I'll explain to the Court, what I propose to do is to go to the implementation paper, which discusses the depreciation issues first, then to the 2004/5 determination and then to Justice Winkelmann's judgment. That's what I propose to do in relation to it. So the starting point is the implementation paper, which is in volume 3 of the case on appeal, at tab 31.

McGRATH J:
Which of your written submissions...

MR HODDER SC:
This is one that's called, "Written Submissions in Support of Appeal," SC 46/2010 dated 15 October, "New Technologies issue".

McGRATH J:
Thank you.

MR HODDER SC:
If we start at page 1025, this is the section that's really dealing – 7.1 is dealing with asset valuation –

ELIAS CJ:
Sorry what page?

MR HODDER:
Page 1025, and we're at tab 31 of volume 3.

ELIAS CJ:
Yes, thank you.

MR HODDER:

So 166 and 167 set the scene for what is to follow. "In order to estimate the cost of providing TSO services, the Commission must determine the value of the assets used to provide those services. The Commission's choice of asset valuation methodology is primarily driven by its interpretation of the costs of an efficient service provider. Asset valuation is an important exercise in measuring the net cost... as it forms a basis for determining capital-related costs". Then, "In an industry characterised by high level of capital intensity, such as the telecommunications, both the return of capital (depreciation) and the return on capital, will be significant cost components."

ELIAS CJ:

When was this paper, April 2002, this is the one you said came out at the time of the first determination, is that right – was – did somebody say that?

MR HODDER:

No, the first determination, that comes out in March, sorry, comes out in – the 2001/2 determination comes out in December 2003.

ELIAS CJ:

I see, okay.

MR HODDER:

These preliminary papers I think all preceded the first determination, is my understanding.

ELIAS CJ:

Yes.

MR HODDER:

Right, so there's then a discussion on page 1026 about various ways of measuring cost, which are largely – pick up on matters that we have looked at thus far, and then having concluded on pages, if after discussion, at 1027 and 1028 that it's going to value on the basis of replacement cost or that's its preliminary view for reasons that are set out in paragraphs, well these reasons are set out in 183 to 188. So 183 talks about the TSLRIC approach, which it's also using under Part 2. 184 says that's

based on modelling different parts, that confirms that it could be valued on a consistent basis with the TSLRIC modelling and the –

ELIAS CJ:

And the – sorry – the optimised replacement cost is on the basis of the actual network, is that right?

MR HODDER:

Yes. In our case we're using scorched node insofar as it's concerned with the core network, yes.

185 says, let's not use the opportunity costs but "the use of replacement cost as an asset valuation methodology is consistent with matters it must take into account". It goes on, it talks about what the American Federal Communications Commission says about that in terms of forward-looking economic cost.

BLANCHARD J:

Do we have that paper?

MR HODDER:

The FCC paper?

BLANCHARD J:

Yes.

MR HODDER:

I don't believe so.

ELIAS CJ:

What's its context?

MR HODDER:

The context of the FCC paper?

ELIAS CJ:

Mmm, what is it?

MR HODDER:

I don't know, Ma'am.

ELIAS CJ:

It's all right.

BLANCHARD J:

It's referred to in one of the other, it may be it's in the first determination, but there's a reference to it and an indication that it was – if it's the same quote and I'm not sure about that, it was in the context, in a similar context that – it might be worth going to that.

ELIAS CJ:

Are you going to go to the determination after this?

MR HODDER:

I wasn't planning to on the grounds of time, I was going to –

ELIAS CJ:

But you can?

MR HODDER:

– I can, I was going to go to the 2004/5.

ELIAS CJ:

Finish this paper perhaps.

MR HODDER:

That might be convenient – just carry on with this –

BLANCHARD J:

Yes, yes it is the same quote, it's on page 1621 in the first determination. And it's prefaced –

MR HODDER:

This is paragraph 103?

BLANCHARD J:

Yes, and the first sentence of that. "The use of replacement cost is also consistent with the approach taken in overseas jurisdictions in assessing the cost of universal service in telecommunications," so what we're talking about here is universal service?

MR HODDER:

Yes. So there's a commonality.

BLANCHARD J:

And in fact the words "universal service" support – occur in the quote.

MR HODDER:

So the reference is obviously a standard FCC publication reference, but I don't believe it's ever been in evidence in the courts. My learned friend's quite right, in his fourth volume of authorities, the small one, the Vodafone at tab 34 –

BLANCHARD J:

Oh yes.

ELIAS CJ:

Para 225 there, "Because the setting of support levels in excess of forward-looking economic costs would enable the carriers providing supported services to use the excess to offset inefficient operations," et cetera.

MR HODDER:

Yes well, if you have an excess over your forward-looking costs then something will happen to the excess. There is still, I'm hesitant to say, no clarity in the word "cost" – the question of cost itself has a large number of components to it when you drill into it.

ELIAS CJ:

Is "embedded line cost" or "embedded cost", is that historic cost? What do they mean by that? "Legacy cost"?

MR HODDER:

Well again that depends how you define and how you approach the question of cost.

ELIAS CJ:

Mmm.

MR HODDER:

But legacy cost is probably a shorthand of what we are concerned about, where if there is an efficient decision made which then has an impact beyond the year in question.

ELIAS CJ:

Just, not on an immediate look – we only have a little bit of it, it's not immediately, enormously supportive of what the Commission is doing here.

MR HODDER:

Well the Commission is choosing forward-looking cost as opposed to historical cost or opportunity cost. It's using replacement cost, which is forward looking.

ELIAS CJ:

Yes.

MR HODDER:

So I'm happy to try and elaborate –

ELIAS CJ:

But it's not –

MR HODDER:

– but I'm not familiar with the document and it wasn't really discussed at any previous stage of the exercise that I'm aware of.

If it's convenient, we were back at the implementation paper at tab 31 in volume 3 at page 1028, at 188, the conclusion is that it's appropriate to value TSO assets on the basis of replacement cost. And then it addresses at 189 and 190 the question of re-optimisation and explains there is a question that has to be answered in that including, at 190, one possibility is not to re-optimise at all. It may not matter to the efficient costs of providing a TSO service over time and so in the end, as we know,

the Commission comes to a kind of compromise in relation to that, but at this stage it was raised as a question.

Now the meaty stuff about depreciation starts on page 1029 and explains what's being proposed there and it's talking, of course, about the – at 193 about the relationship of – return of capital, return on capital and then gives an example. At 196 it's making the point that the depreciation rate affects the total capital cost, i.e. return of capital plus return on capital, in two ways. First through the depreciation charge and second through the return on capital but the return on capital is a number goes down if there's less capital involved. Then there's an interdependency, and it then gives the example in the table 4. So table 4 offers two profiles, one with a flat rate of return of capital, i.e. 10% per year, the other one is rapid in the first three years and then evens out, and one sees that if the first number is added to the third number you get a total capital cost in the fourth number. So in year 1 on table, profile 1, the total capital cost is 22, whereas in profile 2 it's 37. Conversely if you go to the last year in year 10, it's quite different number for each of the two profiles. Those are almost straight line depreciation profiles.

Then over the page, 1031, at 198 and 199, the Commission explains that in determining the depreciation methodology its primary concern is to select a methodology that enables the TSP to recover the cost of prudent investment and no more. Investments are mostly long-lived and irreversible. The TSP must have the expectation of recovering the costs of such investment in which the assets can usefully be used to generate revenues. I think we're spared the equation.

And then on 1032 there's a description of the various depreciation methods. At the bottom of the box there's a short summary of what tilted annuity involves. "Under the tilted annuity approach the capital costs are higher or lower early in the life of the asset depending on whether the replacement cost of the asset is rising or falling over time. If the replacement cost of the asset is declining over time the capital costs are higher early in the life of the asset".

Then 201, "There are an infinite number of possible depreciation profiles... In order for Telecom to have the expectation that the present value of the net revenues will be sufficient to cover the initial cost of the investment (but no more), the approach to asset valuation must be consistent with the deprecation methodology". Then it discusses –

ELIAS CJ:

Sorry, where is that – at?

MR HODDER:

This is 201, at the bottom of page 1032.

ELIAS CJ:

At the bottom, yes.

MR HODDER:

Then at 202 on the next page, 1033, the Commission says, "A key factor is whether the Commission decides to re-optimise the asset base over time. That is whether the Commission decides to alter the value of the asset base periodically based on change in the optimised replacement cost. If the Commission decides this is appropriate, then the appropriate depreciation methodology is the tilted annuity". And then it offers table 5, is an example of a tilted annuity. And what one sees is the that the return of capital is increasing in the second numbered column, so that by the end of the last year, year 10, there's an increase in the return of capital but a reduction in the return on capital, and a corresponding figure of what the total return on capital is and the percentage change is set out in the second-to-last column.

Now, at the risk of diverting again, can I suggest that at volume 11 of the case, and this is an affidavit of Mr Hird, there are some contentious aspects but all I wanted to do was draw attention to a table which I don't believe is contentious, so if one can have volume 11 at tab 128. It's the affidavit of Mr Hird, or Dr Hird, who was Telecom's expert. And at page 4897 there is a table which demonstrates different kinds of tilts and which may be helpful in understanding how the tilted annuity works. So this forms part of paragraph 25, page 4897 and what – and it's discussed in paragraph 26, the first substantive column indicates what happens if you have a tilted plus 5 percent, in effect a result is that the capital is returned in increasing dollars, conversely at zero it's a constant rate, if it tilts the other way then the capital is being returned in decreasing amounts over the relevant period.

And the point that's made in paragraph 26 is, in their conclusion, it illustrates the fact that the faster the rate future compensation is falling, the higher must be the current compensation to ensure that the value of the original investment is recovered. And it

goes to the point I was making earlier when commenting on Justice Winkelmann's judgment, if you're going to have a very rapid drop-off in the value of your asset, you've got to recover it up front, that puts the cost up, up front. So that's – there's nothing else I want to refer to in relation to that but I just thought that the, showing the two different tilts in the same table might be of assistance.

That leads on to 205, paragraph 205 on page 1034. The Commission says if it's re-optimised after five years, if the rate of change is correctly estimated, the re-optimisation "will not undermine the ability of Telecom to recover the cost of its initial investment. The same is not the case using other depreciation profiles".

Now 206 is important, "Of course, the rate of change of the ORC is unlikely to be estimated without error," I think this was the point that Justice Blanchard was making yesterday. "In this case 're-optimising' creates a risk that Telecom may under or over-recover the cost of its initial investment. If the rate of the change of the ORC is over-estimated, Telecom will over-recover its costs. If the rate of change is under estimated, it will under-recover the costs. However, so long as the estimate is unbiased, the upside will closely mirror the downside". Now this is the symmetric, asymmetric issue, and it's the asymmetric problem which Telecom kept on complaining about to the Commission which eventually the Commission recognises in the 04/05 determination. It's not that there isn't a risk, the question is whether the risk is asymmetric. And the complaint was, we can only get downside, we can't get any upside under the regime you're imposing, that's not a symmetric risk which we can leave and accept that there are ups and downs. Or windfall gains or windfall losses.

McGRATH J:

So it was recognised in which decision?

MR HODDER:

It's recognised in the 04/05 decision, which is the one which is set aside on this point by the High Court.

McGRATH J:

Thanks.

MR HODDER:

Now I can, if it's convenient, go to the 2001-2002 determination, although as I say my intention was to go to the 2004/5, which is the one on issue but I'm in the Court's hands on that.

ELIAS CJ:

No I think it's, it was simply the point that Justice Blanchard wanted to raise with you about the FCC, so carry on.

MR HODDER:

Thank you. Then 2004/5 is to be found in volume 2 at tab 25, and this discussion we can pick up on page 515, which will have a look of familiarity about it because we were there not that long ago. So this is tab 25, volume 2, page 515. What we were looking at before the adjournment was the dynamic efficiency discussion down to effectively paragraph 68, but for our purposes we pick it up at paragraph 69, the Commission says, "In our revised draft," i.e. the document that preceded this one in the consultation process, "the Commission separated its optimisation into two separate classes", exogenous optimisation and endogenous optimisation, and exogenous was the introduction of new technologies, endogenous was maintaining the technologies but improving or optimising within them, and, it says, "For the elimination of doubt, Endogenous Optimisation includes the MAR capping technology."

Paragraph 70 points out that in the revised draft it noted that exogenous optimisation could result in the asset base being decreased. Under an ex post implementation of the scheme the Commission noted that an expectation of decrease in asset value, without any offsetting adjustment, would mean the TSP would expect to be NPV of less than zero on its sunk infrastructure, that is, the TSP first outcome where it could either earn an NPV=0 on its efficient investment or an NPV equals less than zero, as the Commission considered there was a probability associated with these scenarios and the TSP could only have a expectation of an NPV of less then zero on its efficiently invested capital. And at 71, "The Commission considered in the Revised Draft Determination that this asymmetry arising from Exogenous Optimisation could not be regarded as *dynamically efficient*. Subject to such an expectation, an incumbent TSP would never have the incentive to undertake the initial investment, and a potential TSP competitor with new technology would never have the incentive to enter such a market."

Then it sets out a series of the submissions, the paragraphs 74 to 76 explain the asymmetry that Telecom complained about consistently. So, for example, at paragraph 74, quoting from a Telecom submission, "The central problem with the past model was the optimisation process was one-sided (i.e., asymmetric). The best that the TSP could hope for was to recover its investment in line with the tilted annuity, and no more" – downside, no upside. And then in 76 the complaint is reframed as being defeating its legitimate expectations in relation to that.

So then there is 518 and following, there are the submissions and reliable persons, Vodafone and TelstraClear in particular and their experts, and then at 520 we get the Commission's view on the expert, on the efficient service provider and its conclusion on this point. At 91, the Commission says, "We have always noted the potential problem of asset stranding. The TSP will not have the expectation of achieving NPV=0 if this risk is unaccounted for ex ante." While the Commission did not believe it was necessary to provide ex ante compensation for such a risk, the possibility was contemplated in the 2001/2002 determination. 92 repeats the absence of an expectation of NPV=0 would have a negative impact on dynamic efficiency. Then, "While the introduction of new technologies in each year may be consistent with achieving some measure of *productive efficiency*, the Commission considers that if repeated annual Exogenous Optimisation results in the expectation of NPV < 0, it cannot be considered dynamically efficient." And then 95, "The Commission also maintains that even if no new technology is introduced into the modelling process in 2004/2005 onwards, static *productive efficiency*" – i.e. the efficiency we understand Justice Winkelmann to be concerned with – "is still being achieved through the combined use of Endogenous Optimisation" – which is what is described in paragraph 69, second bullet point – "and replacement costs" – which are described for example in paragraph 58, back on page 513. To avoid incentives of cost-padding, the Commission uses the historical cost of Telecom only to a limited extent. The Commissioners have employed a formal optimisation technique using replacement costs to determine the asset base from which the normal rate of return on and of capital is calculated.

So, back to paragraph 95, the Commission's saying, we think we've got static productive efficiency still being given a decent nudge through the combined use of those two considerations, and then paragraph 97, in its previous determinations the Commission considered that the asset stranding risk was compensated for in the

cash flows or could be compensated, "but did not do so because of an expectation that windfall losses would be offset by windfall gains", i.e. the risk would be symmetric. "This expectation has not materialised because the lower cost of new access technologies has consistently resulted in revaluation losses rather than gains. As this expectation is no longer valid, the Commission considers that so long as Exogenous Optimisation continues it should compensate the TSP for this risk." Now, if we stop there and just pause, we say, that's the Commission working through the logic of its scorched node and NPV=0, and, with respect to the other arguments, there isn't much room for complaint about that. It's recognising there was a problem, it thought there was a symmetric risk, it turned out to be asymmetric, and it says, we have to do something about it, i.e., there should be a compensation. And that may well not have provoked concern, but that was certainly a matter we would have said was probably unarguably a matter for the Commission to determine in giving effect to the modelling, assuming its modelling was legitimate.

But what it then goes on to, and which causes the excitement, is it said, well, we could compensate or we could not introduce exogenous optimisation, because every time we introduce exogenous optimisation we've got to compensate for it. So the simplest thing is, we don't introduce it, we don't compensate, and that's why it stops exogenous optimisation, that's why it doesn't model mobile technology, and that's what it's saying in paragraphs 98, 99 and 100.

ELIAS CJ:

All of this is driven by its choice, isn't it? Is there a requirement to reassess whether this outcome is consistent with the statutory definition? I mean, it's all being driven off the model and at not providing the effect that had been expected.

MR HODDER:

Well, the answer that we would give is, "No." What the Commission was entitled to do was to produce what it thought was a net cost for an efficient service provider making decisions over time.

ELIAS CJ:

Yes.

MR HODDER:

And it said, "We got that slightly wrong, we need to tweak the model," and that's what it was doing, that doesn't get it into legal error unless there's something completely irrational about it. But what has caused excitement is it's gone through it in two stages, or three stages. The first is to say, there's an error or there's a problem, so we're not actually achieving what we set out to do and, secondly, in terms of solutions, we have a choice, and we make the choice that rather than introduce a factor that has to be compensated for is we don't introduce the factor and we don't have the compensation. And that's, we're saying, a perfectly orthodox matter for the Commission within the various legal constraints or limits that I sought to describe in relation to the first appeal, and the question then is, well, where did that go wrong? For that we then need to go to Justice Winkelmann's judgment.

Well, perhaps just to complete the picture where this takes us to. Page 525, just briefly, at 121 the Commission sets out the options it had to deal with the problem. Option 1, continue to optimise, option 2a, ex post compensation, option 2b, different tilts and bring forward timing of the introduction. Then it gives its conclusions on that topic at page 531, paragraphs 150 and following. So paragraph 150, the expectation, paragraph 151, the problem: we now have an expectation of NPV of something less than zero. Paragraph 152, many ways to solve it, including a complex change to the tilt, 153 says, "Ordinarily you do it through the cash flows but its equivalent in economic terms is no longer introducing new technologies, this is a simple and direct way of accounting for the asymmetry that would otherwise be created. Hence 154 is no longer introducing new technologies, thus ensuring that NPV=0 outcome and dynamic efficiency will be achieved".

And that's in part reflected through in the next few pages as well, where the Court, where the Commission is dealing with asset valuation and doing so on the basis of the NPV=0 rule. And the titled annuity is dealt with in some detail on pages 534 and 535 using some actual numbers and the example, sorry using some numbers and the example at table 2. But these have some similarity to the Cornerstone document we were – the implementation document we were looking at earlier.

So that then takes me to Justice Winkelmann's judgment, which is volume 1 of the case at tab 11. Now, perhaps just briefly, in the earlier stage of the judgment at paragraph 37 on page 367, Her Honour had access to the Court of Appeal decision which came after argument in the High Court in this particular matter. My recollection

is, but I'll stand to be corrected by my learned friends if I got it wrong, is that there was a question mark as to whether any further submissions were required. I think in the end everybody decided no further submissions were required. With the benefit of hindsight that may have been an inefficient decision, but in any event there were no further submissions addressing this particular matter so Her Honour then had it and at 37 she says that the Court of Appeal decision wasn't determinative of these proceedings because the appeal was put to the Court on the more restricted basis that mobile technology ought to have been included in a particular way. "The issue in these proceedings is in a sense more fundamental, namely whether the Commission erred in resolving to cease modelling new technology".

With respect, the point that I'm attempting to make is that's not, in our submission, correct, the fundamental question is whether the Commission is entitled to use a scorched node mythology and if that was correct, which is what the Court of Appeal said it was, then the factor was correcting it, which is what it did in this case, is not within the scope of judicial correction, subject to the extreme aberrance limits. And so in our submission, again, that doesn't capture really the issue that is most fundamental in this concept here, nor –

TIPPING J:

Isn't what Her Honour said simply a sort of, a layman's way of putting the complaint?

MR HODDER:

I, well I don't believe so, Sir. When she –

TIPPING J:

You've just said that – you've just shown that the Commission eliminated new technologies from its modelling because of this netting off business, isn't that what the Judge is actually saying in simple terms?

MR HODDER:

Well, I hadn't thought that, I thought she was saying that the question of whether or not to model new technology was fundamental, but it's not fundamental, it's an outworking of correcting the scorched node model.

TIPPING J:

Well, but – forget the fundamental, the question surrounds the ceasing of new technology doesn't it, or does it not – have I completely misunderstood?

MR HODDER:

The question is whether or not ceasing to model new technology is a legitimate way of tweaking the –

TIPPING J:

Yes.

MR HODDER:

– scorched node.

TIPPING J:

Yes.

MR HODDER:

Yes.

TIPPING J:

Yes.

MR HODDER:

I'm happy if we put the word "fundamental" to one side –

TIPPING J:

She's contrasting the particular with the more general, perhaps she should have said "general" rather than "fundamental"? She talks about the Court of Appeal being concerned in a particular way. She says this is a more general.

MR HODDER:

She does, but again –

TIPPING J:

Are you saying it's not more general?

MR HODDER:

In our proposition, the fundamental issue in the Court of Appeal was whether or not scorched node was legitimate, and the fundamental issue on this appeal is whether or not tweaking the scorched node is legitimate, that's how we would put it.

ELIAS CJ:

Well, correcting it, because it wasn't performing as expected.

MR HODDER:

Correct, yes. So it may be that I'm distracted –

TIPPING J:

I think with respect you may be putting a bit, this a bit high, but it's surely the substance of the thing that matters, not how the Judge described it.

MR HODDER:

Yes, Your Honour, I accept that. The essential part of the Judgment is, for our purposes, starting around paragraph 62 and thereon, and we've – saw some of this earlier today and perhaps 63 is the starting point. I took the Court to 63 before the adjournment. And then the beginning of the discussion which, the discussion was really from paragraph 62 to 75, is where the – Her Honour is addressing the court of the issue and it's perhaps significant that it's early on that we get to her paragraph 66, which we discussed before, where she's saying, "It seems unlikely that the model developed by the Commission was ever well designed to function as a cap or check on the actual costs that Telecom was able to recover from other liable persons". And so there there's a degree of dissatisfaction or rejection, perhaps, of the scorched node as a model, as opposed to what we submit is the issue, which is whether or not accepting the model in the way the Court of Appeal had, it was entitled to be corrected for the error which had been identified and the way that I've taken you to in relation to the 2004-5 determination. And she notes at the end of 66, "I note this particular criticism of the model is inconsistent with the majority decision of the Court of Appeal, but is in any event an issue that is not determinative of these appeals". But in our submission it is. Because inference on the scorched node model and the Commission's entitled to correct for something it didn't take into account.

And then she comes to 67 –

ELIAS CJ:

Yes, I must say that I had read what follows as arguments, perhaps not considered by the Court of Appeal, but pointing in the direction of the majority decision was wrong.

MR HODDER:

Well, she addresses the arguments rather earlier. Vodafone's submissions were addressed back in paragraph 50-something –

ELIAS CJ:

Yes.

MR HODDER:

So from paragraph 52 to paragraph 56 she sets out Vodafone's arguments –

ELIAS CJ:

Yes.

MR HODDER:

– that I have read the judgment as this being her own reasoning.

ELIAS CJ:

Yes.

MR HODDER:

Your Honours, I note it's now almost 1.00 pm. One of the issues perhaps is whether or not the Court has the ability to sit at two rather than 2.15 if we have a concern about timing. Perhaps that's not a matter the Court wishes to determine now.

ELIAS CJ:

It's being suggested it won't make much difference. I'd like to try if other members of the Court are happy with that. Yes, 2 o'clock thank you.

COURT ADJOURNS: 12.58 PM

COURT RESUMES: 2.00 PM

ELIAS CJ:

Yes, Mr Hodder.

MR HODDER:

Thank you, Your Honour. I was addressing Justice Winkelmann's judgment, which is in volume 1 of the case on appeal at tab 11. I think I'd been addressing the Court on her paragraph 63 on page 376. What I propose to do is just to briefly run through the rest of this judgment with my sort of oral annotations if I can put it that way. In 64 she says, "The scheme of the legislation is clear. The distribution of the costs amongst telecommunication providers was recognised to have the potential to distort the competitive process. For that reason the definition of 'net cost' utilised in the Act imports the objective standard of the efficient service provider". I think just one – the only other point we make is Justice Arnold pointed out in his judgment the distorted fact it was TSO in the first place, and if we didn't do something about it, that was a distorting factor, it wasn't so much the distortion between the TSPs unless by that she was including Telecom picking up the cost of it. So that aspect is sort of articulated there.

In paragraph 65, she says, "... the use of the efficient service provider standard is a mechanism to encourage Telecom to provide its services efficiently by depriving Telecom of the ability to recover its inefficiently incurred costs." Two points about that. One is that "inefficiently incurred" does depend on the time you look at them, so if you do it with the benefit of hindsight you have a different perspective than if you do it with an ex ante basis, and –

ELIAS CJ:

Or a forward-looking basis?

MR HODDER:

Yes, if you know you're not going to recover on a forward-looking basis –

ELIAS CJ:

Yes.

MR HODDER:

– then you are being deprived.

ELIAS CJ:

Yes.

MR HODDER:

Yes, yes. And, although it's perhaps more clear later on, like in the next paragraph there's a sort of implication or inference that's what's been talked about are Telecom's actual costs, so 66 I think we looked at before, "It seems unlikely that the Commission was ever well designed to function as a cap or check on the actual costs that Telecom was able to recover..." And then she talks about inflexibility, and I addressed already the point that the particular criticism of the model is inconsistent with the majority of decision of the Court of Appeal but is, in any event, an issue that is not determinative of these appeals. And our point is that it's correct to say it's inconsistent with the majority decision of the Court of Appeal because the majority decision of the Court of Appeal says that scorched node is a legitimate choice for the Commission to make. Then the issue in this particular field is whether or not it was appropriate to correct for a perceived error and that point is determinative of the appeal, as we say, so the logic of the Court of Appeal majority decision is that the Commission's entitled to apply scorched node and entitled to apply it in the way it sees fit, if that's correct then this appeal – Justice Winkelmann's judgment is in error.

Then 67, echoing as we've heard from my learned friend for Vodafone, "The model also assumes a level of initial capital investment by Telecom that is not made." Well, that happens when you use a hypothetical construct including forward-based modelling on an optimisation basis, that just happens. "The initial determination proceeded on the basis of a new and optimised access network, whereas Telecom was providing access on a network that was aged, and acquired by it many years before... On an ongoing basis, the modern equivalent asset valuation methodology... may also result in more capital being ascribed to Telecom... than actually employed by it" – that's a bit unclear, I have to say, to me because the question is how you value it in the first place, so how long it organises a comparison of what's been ascribed to it and what it's actually employed, the question is well how do you ascribe what's actually being employed. The comparison isn't done in the Commission's exercise, and we say it doesn't have to be done under the statute because the statute's concerned with the efficient service provider, not with Telecom itself. "It may well cost more than the original asset that at the time of purchase." Well, again the inference from the Commission is that's unlikely because of efficiencies being achieved generally, but in effect it doesn't matter. Once the decision is made that you have to have a model and a decision is made about which valuation basis you use.

And then comes back to this concern, "The modelling approach therefore risks providing more than a reasonable return on the capital Telecom actually uses". But again, with respect, it's in answer to the wrong question. It isn't an issue if one is applying an ESP approach, an efficient service provider approach, and then, then what she does is she quotes from the 2001/02 determination where the Commission said, "A real world network – real world access network may have a lower capital value than a theoretical one if the capital value is calculated by taking the depreciated value or economic value rather than considering the cost of replacements". But the word "if" is critical. It all depends which valuation basis you use for the purposes of the hypothetical exercise that the statute requires.

And so in 68 she comes back to the point in the second sentence, "The capital investment the Commission refers to in this reasoning is not the capital that Telecom actually employs," we agree, but that's not the point.

Then at 69, "In ceasing to optimise with new technology the Commission has ceased calculating 'net cost'". Well, obviously we disagree. She says, "It has abandoned consideration of whether Telecom's costs are efficiently incurred and whether services could be more efficiently provided through the application of new technology." But it hasn't, it's still applying net cost of an efficient service provider making decisions as year-by-year and with the expectation of NPV=0. But her concern is the "sole focus has become ensuring NPV=0". So then the question is, is NPV=0 a legitimate principle for the Commission to apply in this modelling exercise? And we say it is. And then she says, "But the objective standard that is imported by the net cost definition cannot be limited to the provision of a reasonable return of and on capital to the TSP". But, as we've seen, the Commission explains its approach that NPV is what is required to achieve dynamic efficiency, it's what will inspire an efficient service provider. And so the point is not being addressed in this discussion by Her Honour. And then she says, if it were intended to be limited to NPV=0, it would have been set out. Well that's true, it could have been set out, but the language doesn't prescribe any particular detailed level of cost assessment, it simply gives a whole series of considerations which the Commission has to balance.

And then in 70, "Because of its focus on NPV=0 the Commission has excluded from its consideration the possibility that new technology will become available that is so effective that an efficient service provider would invest in it, foregoing a reasonable

return on and of capital invested in the old technology." Now that appears to be hypothesis, I don't know if anybody was suggesting that that was the case before her in relation to the 2004/05 determination. So, in effect, that if an efficient service provider would forego, suffer a capital loss, so that it would invest in new technology. Well that isn't the situation we're concerned with. If it were, arguably, you might be in a situation where you're into the question of asking whether the Commission had gone outside the bounds of rationality, but this is effectively coming up with an extreme example to test whether the judgment applied by the Commission may be open to some question. But being a question of judgment, there's always going to be some questions.

Then the question is, how will you invest in it? On the Commission's scorched node approach the investment will be by way of an adjunct to the core network as opposed to replacing the whole lot, but that issue's not addressed in this part of the discussion.

In 71, Her Honour says, "I understand that both mobile technology and Wireless Local Loop are used by Telecom to provide TSO services but those technologies not effectively modelled by the Commission". Now I need to explain that the first proposition is not correct. I think that's a matter that's common ground between the parties, it wasn't the case that mobile technology is used, there was a discussion when this judgment was released in draft about that, the point was drawn to Her Honour's attention but she thought she wasn't prepared to amend the judgment in those circumstances, and so the matter arises here, but I simply say that there was no evidence and isn't the case that mobile technology was being used by Telecom to provide TSO services. Wireless Local Loop is, was and MAR was and is. And then the next sentence, "Consideration of efficiency must entail consideration of the least cost method of provision of service, inherent in which, of course, is an assessment of the ramifications of historic investment decisions for overall cost analysis". Well "least cost" takes us to the question of static efficiency which we saw in the Commission's definitions, but it doesn't say anything about dynamic efficiency. I don't – I confess I don't fully understand what the last part of the sentence is driving at.

ELIAS CJ:

No, I don't either.

MR HODDER:

Whereas if what Her Honour is saying is you need to have regard to historic cost, and somehow or other that's mandated by law, that may be what is being driven at, but our proposition of course is that's a matter of choice for the Commission. 72, "When the introduction of new exogenous technology is ruled out there is effectively a guarantee of return on and of the notional capital employed..." And what we say that the Judge is doing is elevating the expectation which the Commission says is required, which is NPV=0, into the idea of a guarantee.

But if I could just mention – I took the Court to it earlier – but in the 2004/05 determination, at paragraph 95, the Commission explains it's still encouraging productive efficiency by having endogenous optimisation and by using replacement costs. It isn't ignoring that issue, and therefore there's not a guarantee because those are going to change from the reality. Insofar as it's notional capital that's a guarantee, it probably is saying no more than, "That's what NPV=0 is anticipating," that the party that is investing under this construct is expecting to receive both its capital in terms of returning the actual capital and reasonable return on the capital, and it doesn't really assist, we say, to call it a guarantee in these circumstances. And then at the end of the paragraph 72 Her Honour says, "The approach is inconsistent with the annual nature of the exercise and with the notion that the Commission could only take into account provision of return on the incremental capital *actually employed* by Telecom," and we see there again the italicisation of those words, which we were looking at in paragraph 63, subparagraph (2) which, with respect, has got nothing to do with it.

And there's a concern in terms of the way the judgment is heading, but what it seems to say is, if you're going to have an annual nature of the exercise, that seems to be a proposition that you have to have a scorched earth approach, because that's what an annual exercise requires. Our point is, there's a different time frame, the Act is talking about long-term benefits. 73, "In the two challenged determinations, the Commission has viewed efficiency predominantly from the standpoint of Telecom." Well, with respect, it's from the standpoint of any TSP that is thinking about investment, not Telecom as such. "The need to maintain minimum conditions for investment," and the proposition there is that's what Part 3 is about. You want to encourage investment in the assets that provide TSO services. And then Telecom had submitted in the real world that would drive some efficiencies. Well, in the real world it would. If there's room to make gains by being efficient, then any rational

provider of services will do so, there's nothing unusual about that. But Her Honour is critical at the end of the paragraph, "But the necessary application of this analysis is that the efficiency incentive for Telecom is that the price model allows it to recover higher (inefficient) costs than the costs it actually incurs." And again, the last phrase must be referring to Telecom's actual cost as opposed to the notional network costs.

ELIAS CJ:

It's not a bad counterfactual though, is it? If their costs are less, to then reason that they're not efficient costs.

MR HODDER:

Well, that is –

ELIAS CJ:

I mean, presumably that's how it's being used.

MR HODDER:

Well, it might be, if one was doing a top-down model, but we're not doing a top-down model and there's nothing in the statute that says the Commission's required to do a top-down model.

ELIAS CJ:

Well, I'm not entirely convinced about that.

MR HODDER:

Well, that's the submission, obviously.

ELIAS CJ:

That might be something that you need to come back to in terms of the structure of the legislation.

MR HODDER:

Well, I think I've addressed it, but I just –

ELIAS CJ:

Well, you just say it's –

MR HODDER:

And briefly, the proposition –

ELIAS CJ:

– the choice that they had to make.

MR HODDER:

There's a choice, there's nothing – we submit there's nothing in the statute that says, as between top-down or bottom-up modelling, the Commission would make an error in law in choosing one or the other, and if it makes no error of law it's entitled to choose bottom-up. If it chooses bottom-up, Telecom's actual top-down costs have nothing to do with it, that's our proposition. And because we're talking about the efficient service provider and its net costs, and including the way in which Telecom reports its quote, or the quote "net costs" under section 83, nobody knows what Telecom's actual costs are because, on the way that the Act is applied by the Commission and, we say, within the scope of its powers, Telecom's actual costs are not material. But again, the proposition – Justice McGrath's point, it's implicit in our submission that here Her Honour is favouring a scorched earth approach, because that would answer some of her concerns. Here, both in the end of 72 and the end of 73, although she doesn't explicitly say, "There must be a scorched earth approach," but under her analysis a scorched node approach could never work.

And then at 74, and this is becoming by way of a summary, where Her Honour has gone before, "It is clear that the 'net cost' was not intended to be more than Telecom's actual costs in providing the TSO services." And, again, that's become Telecom-specific. We say that's not clear. What's clear from the Act is that the efficient service provider costs are meant to be the focus of the contributions that are obtained from liable persons. The legislature would not have intended that Telecom's competitors pay windfall profits to Telecom, placing the competitors at a comparative disadvantage. In that context, I draw attention back to the discussion in terms of the depreciation and the risk of the tilt. There might be windfall gain, there might be windfall loss, in some scenarios, because one's projecting forward. But the way in which one deals within the modelling scenario is if they are symmetrical risks then one just simply accepts them as they come. Not to say the whole system has failed and there's been an error of law, if there were by chance to be windfall profits. And nothing, of course, is said in the paragraph about windfall losses.

And again, the last sentence comes back to, "Telecom is not held to a meaningful standard of efficiency at all if it can be confident that it is to continue to receive prices calculated on the existing model, and need take no steps to explore more cost effective means of service delivery." But, again, that isn't consistent with what the Commission's actually doing with the endogenous optimisation and with using replacement costs. Then she says, to conclude, "The Commission was entitled –

ELIAS CJ:

So do you say that it is irrelevant that this modelling means that Telecom has no incentive to explore more cost-effective means of service delivery?

MR HODDER:

The model itself is providing incentives by optimisation.

ELIAS CJ:

But in the real world, Mr Hodder –

MR HODDER:

In the real world –

ELIAS CJ:

– what's the incentive?

MR HODDER:

Because, the lowering. Well, in any circumstance every firm is incentivised to lower its costs and increase its margins, that's the general commercial driver, profits.

ELIAS CJ:

Yes, but it can offload its costs through this, the incremental cost of providing the service to the uneconomic customers.

MR HODDER:

To a degree, well, that's what the system is designed to do.

ELIAS CJ:

Yes.

MR HODDER:

But what, the proposition is if those costs are efficiently incurred, including efficiently incurred over time, that is what is required. In terms of incentivising improvements in the system, that is the two features that the Commission has emphasised, endogenous optimisation and the scorched node in relation to the node to the customer premises. So it isn't as if Telecom is getting, is going to get an automatic guarantee of its actual costs. We don't know what its actual costs are, but the whole purpose of the productive efficiency aspect is designed to incentivise it to improve.

ELIAS CJ:

Do you say that the calculation that Telecom is to provide to the Commission, because it's based on the modelling the Commission has accepted, requires it to provide its actual revenue costs or…

MR HODDER:

Well, there's a choice about that. What's actually happened is the Commission gives directions –

ELIAS CJ:

Yes.

MR HODDER:

– and it's effectively directed that on costs Telecom provides information based on the Commission's model, not Telecom's actual costs, and on revenues that Telecom provides, its actual revenues, although there's some discussion in the papers about providing non-actual revenues.

ELIAS CJ:

Well, I can understand why the Judge recoiled from it.

MR HODDER:

So, at the beginning of 75, "Although the Commission was entitled to use a model," that's the first proposition that we say, if you go that far then the rest of it becomes very difficult, because we say that's the core to it, the Commission was entitled to use a model, including one from bottom-up, which rendered Telecom's actual costs essentially irrelevant. Then it says, "it had to ensure the model calculated net cost as

statutorily defined," as I've been attempting to demonstrate for too long, the net cost definition in the statute is not particularly precise, it requires, among other things, incorporating efficient service provider, and efficient service provider brings an NPV=0 – the whole thing has to be wrapped up into section 18 efficiencies, including dynamic efficiency, but the implication of the sentence is there's some precise statutory definition which the Commission has failed to observe and with respect that isn't made out.

ELIAS CJ:

This might be totally astray, but isn't in fact the model a combination of top-down and bottom-up?

MR HODDER:

Well I think it's better described as bottom-up.

ELIAS CJ:

Right.

MR HODDER:

There is obviously, to the extent that the configuration of the network is the same, that I presume is the basis for suggesting it might be top-down.

TIPPING J:

Depends whether you're standing on your head or your heels –

ELIAS CJ:

Well if you're looking at the existing network, that really is a top-down model in part isn't it?

MR HODDER:

In part, you could say that, except they're not using, they're using optimisation of replacement costs within that –

ELIAS CJ:

I understand that but they'd probably have to do that anyway, wouldn't they?

MR HODDER:

Well not necessarily. They have a whole series of choices which is, essentially, my point. So –

ELIAS CJ:

The – so the new capital costs are in fact confined to replacement under this model – yes?

MR HODDER:

In the model the capital is valued at replacement cost, existing assets.

ELIAS CJ:

Yes, thank you.

MR HODDER:

And so the conclusion that Her Honour is reaching that there was an error in law because by introducing new technology, by ceasing to introduce new technology, it ceased to calculate the unavoidable cost of an efficient service provider. Instead the exercise that it took was to model the net cost of a notional provider using the hypothetical 2001/02 network and guaranteeing a return on that capital over time. But if we just stop and rephrase that. It ceased to calculate the unavoidable cost of an efficient service provider, it rather begs a very good question of what we're talking about here, what does that require. And we say it's the efficiency considerations that the Commission has taken into account. And then the exercise it undertook was to model the net cost of the notional provider, we say that's what the statute requires, using the hypothetical 2001-02 network, that's what scorched node requires and guaranteeing return on that capital over time. That's what NPV=0 contemplates. In our submission there's nothing in that sentence that anybody could be concerned about, and certainly not as an error of law.

And then she comes back to the same phrase again, "Has it implicitly accepted it designed a model that could allow net cost to be set at a price higher than Telecom's actual costs?" We don't know, but if it was that's inherent in the particular modelling which the Commission has to undertake.

ELIAS CJ:

Has chosen to undertake.

MR HODDER:

Correct.

ELIAS CJ:

Yes.

MR HODDER:

Yes, as a legitimate choice we say.

ELIAS CJ:

Yes.

MR HODDER:

There's probably not much else I can say on this topic. The general proposition, if I come back to it though, is if the Commission is entitled to model, to determine what the net cost to an efficient service provider is, and we say it is, then it's entitled to choose bottom-up and it's entitled to choose the NPV=0 principle as part of its approach to this whole exercise. I don't understand any of those to be directly challenged in the judgment as being errors of law and yet, by a conclusion, a sort of a factual conclusion, i.e. that Telecom's actual costs might be being – might be higher than the cost that the model contemplates, the learned Judge comes to the view there's an error of law. In our submission that doesn't suffice to carry the day on the topic. So there is still the initial proposition we have from *South Yorkshire* that these were matters for judgment, they're not questions of law, the concerns that the Judge has were really in relation to choices that the Commission was entitled to make.

So if it's convenient that takes me to –

ELIAS CJ:

Yes, I'm sorry – just –

MR HODDER:

Sorry, no, not at all.

ELIAS CJ:

– just if you were modelling on a top-down basis –

MR HODDER:

Yes.

ELIAS CJ:

– then you wouldn't model to permit a higher cost recovery than was actually incurred, would you?

MR HODDER:

You wouldn't, you wouldn't expect to do so, whether by some –

ELIAS CJ:

You'd model to not achieve that?

MR HODDER:

Correct. As says the Commission.

ELIAS CJ:

So if you move to a combination of top-down and bottom-up, I think that's really what the Judge is driving at in this paragraph. If you had simply gone bottom-up you would have gone for the most efficient provider, but it's the combination that leads to a result that she says is –

MR HODDER:

Unlawful.

ELIAS CJ:

– well maybe it is unreasonable on that reasoning.

MR HODDER:

I think the response would be that no doubt every modelling option has various oddities or anomalies within it, that's the nature of modelling.

ELIAS CJ:

But this is not a pure model.

MR HODDER:

Well if one has – even with a pure model you have either anomalies or difficulties, if one accepts it says scorched earth and bottom-up is a pure model, there are still difficulties because you have a real issue about whether you're achieving dynamic efficiency and investment for long-term asset development. The proposition is that there is no right –

TIPPING J:

Has it ever been suggested – has it ever been suggested in this case by any party that it was irrational or unreasonable or unlawful as to which of the bottom-up, top-down approaches was adopted?

MR HODDER:

I don't believe so.

ELIAS CJ:

Well I thought there was consideration in one of the judgments, I might have that wrong. I thought the Court of Appeal judgment –

MR HODDER:

In the Court of Appeal both Vodafone and the President accepted that scorched node was available.

ELIAS CJ:

Mmm.

MR HODDER:

And if you have scorched node then the, kind of the, you can't have scorched node and have the purity that the Chief Justice is suggesting.

TIPPING J:

This is the irony in it. Once you go that far, it seems that you're almost at the destination that you challenge.

MR HODDER:

I'm not sure I follow that, Sir.

TIPPING J:

I won't worry you then, Mr Hodder.

MR HODDER:

No, I'm sorry, but –

TIPPING J:

What I'm trying to say is if you accept that scorched node was an acceptable approach –

MR HODDER:

Yes.

TIPPING J:

– then it becomes difficult, I would have thought, to challenge where that logically leads you to.

ELIAS CJ:

I agree with that, if that point is being made to me. I agree with that.

MR HODDER:

Well, that is my point.

ELIAS CJ:

Yes.

TIPPING J:

Was it? I thought – well, that was put to Mr Gray and I'll be interested to see what more he wishes to say about that.

MR HODDER:

Well, just to be clear, I mean our entire case I have this as, have got some clarity, is that in this area the Commission was entitled to make a choice of scorched node and it was entitled, that's the first appeal, and therefore the majority of the Court of Appeal was right to say there was nothing erroneous about its choice of scorched node; and in relation to the second appeal, when it seeks to correct that, as

it does, in relation to the exogenous versus compensation trade off, then that's not an error either, that's simply a logical outworking of where it is. So I – Justice Tipping's proposition is one that is entirely comfortable for our case.

GAULT J:

I understand that it really has been accepted by all those involved that scorched node was an acceptable or available approach. Now, is there some argument that it was not?

MR HODDER:

As I understand Vodafone is saying, yes there is.

GAULT J:

Well, I can understand Vodafone saying it was acceptable but on the way they consider it should be applied it's led to error. I didn't understand them to fundamentally question the approach.

MR HODDER:

Well, I may have misunderstood it. I thought that's where my learned friend had moved during the course of his oral submissions.

TIPPING J:

It wasn't entirely clear to me whether he'd abandoned scorched node and was going for scorched earth.

ELIAS CJ:

I'm simply trying to understand it. It may well be that at the end of the day the case has proceeded on a basis that makes it irrelevant, and in any event you have your primary submission that it's all a matter of choice in any event for the Commission, but I think the Judge is not accepting that scorched node, in the paragraph, and well, leading up to it, was reasonably available.

MR HODDER:

Yes. I think that's correct in the way that Her Honour's judgment reads. In relation to Justice Gault's point, I think there are two levels. I mean our case is that there is an area of choice for the Commission but there are boundaries to the choice, and I don't want to misrepresent my learned friend's submissions, I understood him to say at the very end of his submissions, as an alternative, if his primary submission which I must

say I rather understood was that scorched earth was effectively where they had to go, to avoid error of law, that if scorched node was available, then the way of carrying it out, i.e. on the adjunct rather than the overlay basis, was not rational, not reasonable. So that's a more detailed issue in which we say it doesn't come close to that, there's nothing inherent in the documents that demonstrates on its face some serious problem.

So with my talking about the serious problems on their face, that then brings me to the asset beta appeal. And there are separate written submissions on that which I call "Written Submissions For Appellant Telecom In Support Of Appeal SC 45, Asset Beta Issue," and the Court may recall that the issue here is that in its early determinations the asset beta, which is an important multiplier in the assessment of the average cost of capital, was assessed by the Commission at 0.4. But as what it regarded as a consequence of the matter we've just been talking about, that is to reduce, to stop modelling exogenous optimisation, it decided to cut that in half to 0.2 and there is, there's a seriously substantial monetary consequence of that as far as Telecom is concerned, as we say in our paragraph 1.6, "We think it reduces the weighted average cost of capital from 7.1 to 5.7 for one year and 7.4 to 6 for another," it's worth about $14 million a year on the simple cutting it in half.

So the question that we ask in this appeal is, why do they cut it in half? And the answer is given as, well, we did that because we've removed some of the risk of technological change. And our basic point is, but you didn't include any factor for technological change at the outset, so how can you take it away? But it's the essence of the appeal. Now I've constructed, on my analysis of the law that I'm putting to the Court, a reasonable threshold to get over in terms of accepting the Commission has a series of discretions. My point in relation to this appeal is on the face of it, there is simply a blatant inconsistency in the approach the Commission took in 2001/02 and would have taken in 2004/05, and that's the point that I wish to address and I need to do it really by reference to the Commission's 2001/02 determination, which is volume 4 of the case on appeal, at tab 48. So for context perhaps I can invite the Court to look first at page 16 – it's not marked on my copy but it's 1626, which is under the heading "TSO Cost of Capital," at paragraph 127.

GAULT J:

Where do I find that page?

MR HODDER:

Volume 4 of the case on appeal, Sir, at tab 48.

ELIAS CJ:

And the page 1 –

MR HODDER:

1626.

ELIAS CJ:

Thank you.

MR HODDER:

So, this is the beginning of the discussion of the TSO cost of capital, there have been preliminary papers but in the circumstances and time I wasn't proposing to go back to the earlier papers. I have given you references in that paper I handed up yesterday under the relevant column. So the introduction is set out in 127-128, "a reasonable return on the incremental capital... the reasonable return is the opportunity cost of the funds invested in the network and non-network assets by an efficient service provider. It is the rate of return an investor would expect to achieve by investing in assets with a similar risk profile. If it's not able to earn its cost of capital, its incentives to invest in TSO assets will be undermined". Then 128 refers to its previous discussion documents as well as the fact it's had to look at cost of capital issues in relation to airports, electricity and dairy.

I hope it's of some relief that I don't need to go into the WACC equations on the balance of that page or the next couple of pages. But first of all there's a question about choice of model, that's not an issue, they use what is a relatively well-known in New Zealand, Brennan-Lally Capital Asset Pricing Model. On page 1630 there's a discussion of the risk-free rate, which we don't need to spend time on, but what we do need to focus on begins at page 1636, which is where the discussion of the beta arises.

Now I'm, I suspect this Court hasn't had to escape capital asset pricing models and betas in the same way that most of counsel have had to – had not been able to escape them ever, but the general proposition is explained quite well, with respect,

on page 1636. In the middle of the equation, one inserts the concept of a beta, described in 179 as "the risk of an investment relative to the market risk". It relates to the volatility of returns, the possibility that expected returns may not actually materialise or maybe higher than expected, and the total risk of an asset or business is made up of both diversifiable risk and undiversifiable risk. And all this comes from corporate finance of course and – with its own language – jargon.

So firstly, diversifiable or unsystematic risk is unique to the asset or firm and can be eliminated by diversification. The risk associated with technology obsolescence, which is a key phrase for us, et cetera, are examples of unique risks. So if I'm in a business that depends, for example, on a patent that has a – that's – I have a particular risk that my business has that no other business may have. Undiversifiable or systematic risk is market risk which isn't unique to the firm, and that risk cannot be eliminated by diversification. It's related to, dependent on the state of the economy as a whole, so if I am selling a product that depends on consumer optimism and I go up and down with the market, that's something I can diversify, well I can't diversify against the way the market goes up and down – if I'm selling my narrow niche patented product, as an investor I'm expected to diversify, in case that has a particular unique risk, and my basket of investments means that I am sufficiently diversified not to be exposed to the unique risks which are those which are described as unsystematic. So, that's the issue, well that's the beginnings of the issue.

180, "Under the framework of the Capital Asset Pricing Model only the undiversifiable risk", that is the systematic risk, "is relevant in determining the cost of equity. Investors are not compensated for diversifiable risk", i.e. technology obsolescence doesn't feature in the capital asset pricing model. "Beta measures the sensitivity of the asset's return relative to markets returns. Its estimation is one of the most contentious... and also significantly affects the resulting WACC." And then it goes onto describe the asset beta, that's effectively the same thing, but you take out any question of debt. And so here we're talking about asset beta which for these purposes there's no great scope in relation to that. And that point about the debt is dealt with in paragraph 185 as well.

TIPPING J:

We're only concerned with asset beta, not equity beta?

MR HODDER:

Correct. But for practical purposes there's no real difference where we're concerned. We're not concerned with leverage issues here. So then at 188 the Commission sets out how differences in betas might arrive, remembering that what betas are measuring are matters that relate to undiversifiable risk, i.e. systematic risk, and it goes through and talks about the nature of the product, the nature of the customer, pricing structures et cetera, et cetera, all of which are reasonably general and none of which relate to technological obsolescence or stranding risks. The only point I need to make for present purposes.

189 on page 1639, 1639 – the Commission says, we can now describe the insurance effect and the requirement to annually review costs to see how they impact on the TSO asset beta, and it talks about variations of economic activity which impact upon revenue levels.

TIPPING J:
What's the insurance effect?

MR HODDER:
The insurance effect is that instead of a few people in your CNVC cost going broke and not paying you, you actually recover the net cost on those things from somebody like Vodafone who isn't going to go broke. So you're insured against the risk of non-payment by a random selection of customers.

BLANCHARD J:
But here the insurance effect is relatively small.

MR HODDER:
That's what the Commission says, and particularly it relates to revenues as opposed to costs, and there's a separate analysis for each as to which of them is affected by this. So there's an insurance effect, relates to revenue levels, but the Commission says it's not very significant.

ELIAS CJ:
You said that asset stranding isn't one of the factors identified but –

MR HODDER:
In 188.

ELIAS CJ:

In 188, but doesn't it come under industry factors?

MR HODDER:

Ah –

ELIAS CJ:

I know that the examples are given by the type of product and so on, but surely it must be an industry factor?

MR HODDER:

I don't – I'm not sure that follows. Well, I mean, the point that's made in 179, that the very thing you don't take into account is technological obsolescence, but that is a unique scenario for the TSO provider not an industry factor that affecting a wider industry. That's the –

ELIAS CJ:

But if all providers face the same risk, isn't it an industry factor rather than a fact –

MR HODDER:

That seems plausible. I'll come to the point. There's a discussion later on that says there is a kind of an inherent diversifiable risk, sorry, undiversifiable, systematic risk, in relation to technology obsolescence.

ELIAS CJ:

Yes.

MR HODDER:

The point that I'm going on to make is that the Commission doesn't weigh that in terms getting to its 0.4 beta for this year, and then takes half of it away when it gets to 2004/05. So Your Honour's assumption I think is correct, that it can be an aspect of it.

BLANCHARD J:

What's the market in this context, is it the market generally?

MR HODDER:

I think so.

BLANCHARD J:

Yes.

MR HODDER:

If you were talking about the market that's –

BLANCHARD J:

So it's not –

MR HODDER:

– been referred to in paragraph 179 and 180 and 181, yes –

BLANCHARD J:

– yes, so it's not –

MR HODDER:

– that's why you diversify –

BLANCHARD J:

– just a market for the particular industry?

MR HODDER:

I don't believe so. That's why in 181 is talking about market returns –

BLANCHARD J:

Mhm.

MR HODDER:

– and the diversification concept of a diversified portfolio is designed to deal with the market in a wider sense.

McGRATH J:

And the state of the economy as a whole –

MR HODDER:

Yes.

McGRATH J:

– is the concept it's referring to?

MR HODDER:

Yes, yes. So the contrast is between the market as a whole, that is effectively the productive part of the economy and its fortunes, versus the TSO provider, in its role as a TSP provider not in its wider role, for example, as Telecom, and that's what the focus of this discussion works its way through.

Now, there's a lengthy discussion in all this which I'm going to have to skip through. There is some systematic – after 189, which is where I was, on page 54, 55, there's an introduction to the topic of various TSO-specific issues. At 197, there's a discussion about systematic risk associated with current-year variability and revenue and cost and default risk, and this is the insurance effect I was discussing briefly with Justice Blanchard, so 198 talks about near-complete risk mitigation in relation to revenues and says, "This 'insurance effect' will reduce the TSO beta" in relation to revenues. Then 199, conversely, it "doesn't provide complete risk mitigation in relation to costs. Costs escalate on a forward-looking basis using an economic/engineering model. The model estimates the cost of an efficient provider providing TSO services rather than the TSP's actual cost." These points keep on recurring. "It is therefore possible that shocks to the cost of the TSO provision will not be compensated by the TSO funding mechanism."

Now just to pause there, the point there is that sort of thing is meant to be picked up in part by the depreciation and tilt. Recording what depreciation is about is also dealing with technological obsolescence. The more risk of technological obsolescence the faster the rate of depreciation is meant to be.

BLANCHARD J:

But 198 is curious. "The TSO loss-sharing mechanism therefore offers near complete risk mitigation in relation to revenues."

MR HODDER:

Revenues, yes.

BLANCHARD J:

But it only does that to the extent of the percentages that Telecom itself is not having to pay.

MR HODDER:

Correct.

BLANCHARD J:

Because this thing goes round in a circle –

MR HODDER:

It does –

BLANCHARD J:

– to a large extent –

MR HODDER:

Telecom still stands the risk itself in relation to its own customers, or that share of it –

BLANCHARD J:

Mhm, so that sentence is, in reality, a bit ridiculous. It's not against you.

MR HODDER:

The question is how much emphasis we put on the word "near". If, I'm not sure what the percentage is –

BLANCHARD J:

"Near", in the sense of being very far away.

ELIAS CJ:

The size of a substantial area of England.

MR HODDER:

To the extent that there is a levy, as my learned friend calls it, placed on other providers, and to that extent, I think that's what it's talking about. The point Justice Blanchard made is one we happily accept.

McGRATH J:
It's in relation to the revenues that other –

MR HODDER:
In relation to the revenues –

McGRATH J:
– providers produce, that's what –

MR HODDER:
– yes.

McGRATH J:
– and if you see it in that way, it does make sense.

MR HODDER:
Well, to the extent that the revenues are not revenues at a risk of not being paid because Telecom's own customers default.

McGRATH J:
No, but if you see it, the revenues that come through the other providers?

MR HODDER:
Yes, yes.

BLANCHARD J:
Mhm but they're a relatively small proportion.

MR HODDER:
Relatively, yes.

ELIAS CJ:

In 199, you say, makes sense because, you say that, they have modelled an efficient provider –

MR HODDER:

Yes.

ELIAS CJ:

– providing the TSO services.

MR HODDER:

Rather than TSO actual costs, that's correct, but it says there are still possibly going to be shocks. There are two things about that. If the shocks are symmetric risks of shocks, then that doesn't – in the way the world works here, well I hope that it all works, it doesn't matter. If they're asymmetric, there can be a problem, they need to be dealt with, and the way that they're normally dealt with is by way of annuity tilt designed to achieve the recovery of capital which is the asset stranding risk. If you can recover your capital then the stranding is no longer of economic significance.

Then at 202, the Commission comes back to the point and says, "Assessing the risk mitigating effect of the TSO funding mechanism involves weighing up its impact... The Commission considers that the systematic risk of the TSO is more likely to be related to revenue and have only a moderate relationship to costs." So we've got revenue taken care of by the insurance mechanism and it doesn't have much impact in relation to costs.

At 204, the heading is then discussing systematic risks associated with a regulatory error, i.e. if the regulator gets things wrong, particularly in discerning future discount rate, i.e. the rate of return, then that is a problem you're going to have. There's a risk about regulator error and that of course is accepted but that had to be factored in at the beginning and it's got nothing really to do with mobile technologies, which is our point.

We go onto page 1644. This is a discussion about the risk associated with optimisation, beginning at 212.

TIPPING J:

Have we got to where inconsistency bites yet, Mr Hodder?

MR HODDER:

No, I'm trying to set a platform for that, Sir, but we're getting close. So this becomes quite significant. At 212, the Commission identifies that there can be a risk, a systematic risk, where there's re-optimisation. At 215, the Commission says, "it is not clear that the act of optimisation and revaluation... necessarily increases the systematic risk," and that conclusion is quite significant. Then 216, "If asset revaluation risk and the risk of asset stranding are non-systematic", i.e. don't account for them in the beta, then PWC's statement about using electricity firms' betas "may provide a reasonable proxy for the TSO asset beta."

The point that I'm getting to, encouraged by Justice Tipping's comment, is that what the Commission does here is it says, in a sense, we're going to set 0.4, how do you we get there, we're going to take US electricity firms that are regulated on a rate of return basis using historic –

TIPPING J:

Now you're sort of jumping –

MR HODDER:

No –

TIPPING J:

– I'm sorry, I know I provoked this, but are you able to encapsulate, in a sentence or two, where in all this the inconsistency is to be found?

MR HODDER:

I hope so.

TIPPING J:

Well, can you not –

MR HODDER:

So –

ELIAS CJ:

Jump to it.

TIPPING J:

Well, saying 0.4 out of nowhere doesn't help me.

MR HODDER:

Where all this is leading to in this particular determination is that 0.4 beta which the Commission determines –

TIPPING J:

Ah, the 0.4 beta.

MR HODDER:

That 0.4 can be deconstructed into two components: 0.3 is by reference to the regulated electricity firms, essentially from the US, and the Commission takes 0.3 from there and it adds 0.1 for what it calls an "industry factor", so A plus B gives you 0.4. Now the thing about the US electricity firms is they are rate of return and they use historical cost. Because they use historical cost there is no technological obsolescence risk.

ELIAS CJ:

Mmm.

MR HODDER:

So that's – 0.3 plus one, when you take away mobile technology the Commission says, aha, we've reduced the risk of technological obsolescence, we're going to knock that 0.4 in half – it becomes 0.2 and that's the point when Telecom says –

TIPPING J:

How do you get half of 0.3 being 0.2?

MR HODDER:

Well that's – we say 0.3 doesn't change at all because there is no technological risk of the 0.3 component.

TIPPING J:

I'm just trying to follow the arithmetic that's all.

MR HODDER:

Well there is no following the arithmetic, that's our submission. So the point about 0.3 is that it has no technological obsolescence in it because of the nature of where it came from. So when you remove a risk of technological obsolescence by not modelling new technologies, there's nothing to remove from the 0.4 but the Commission has removed half of it, and we say that simply doesn't make sense.

ELIAS CJ:

It removed it for the risk of asset stranding?

MR HODDER:

Correct.

TIPPING J:

Which was never in the original 0.4?

MR HODDER:

That's our point, or if it was it was bare minimis. But then it's – staying with page 1645 –

BLANCHARD J:

Well what about the 0.1, what do you say about that?

MR HODDER:

That may have included an aspect of the systematic stuff we're talking about, including the costs, but remember that probably related to paragraph 215 which says the Commission's not clear it has anything to do with the systematic risk and the earlier proposition that it says that as far as the systematic risk of the TSO is likely to have a moderate relationship to cost, which is 202.

ELIAS CJ:

What, in the US electricity regulated industries, did the asset beta there adopted represent, what went into those? Why have they used it?

MR HODDER:

Well I can – there's a lengthy discussion in the appendix to this – I'll come to it, if I come to it in just a moment I'll –

ELIAS CJ:

Yes.

MR HODDER:

– get there. And so at 216 there's a conditional proposition. If you treat these risks as non-systematic, i.e. not affecting beta, then electricity firms will provide a reasonable proxy. What the Commission say is they do provide a reasonable proxy and it uses them as to 0.3, so in effect they have removed the "if" from 216 to say they're not, they are non-systematic and therefore don't have to be taken into account. 220 it says, "We do deal with these issues by way of assets, sorry – 220, "The Commission considers that a significant part of the risk of changes" from optimisation from technology risk "may be asset-specific or non-systematic risk, or may be negatively correlated to the market". So if they're non-systematic, they don't count for beta, if they're negatively correlated to the market they don't reduce the beta, the increase the beta –

TIPPING J:

Is this an irrationality point?

MR HODDER:

It is. The entire logic, we say, of this 2001/02 supports some figure higher than 0.4, but let's assume it's 0.4, what it doesn't do is provide any basis for taking half away –

ELIAS CJ:

For taking it away. You don't probably need to take me to the US – the factors that entered into it because you are taking the view that they were a correct proxy or a proxy that was available to the Commission in the original calculation.

MR HODDER:

Well, I can take you there quite quickly, I just wanted to make one or two references before I get there.

ELIAS CJ:

Yes.

MR HODDER:

So at page 1646 you'll see at 226 the Commission says, we're "not satisfied the systematic component of the risk of asset optimisation and the risks of asset stranding warrant any increment to the TSO beta compared to assets valued with reference to historical cost". And the reference to historical cost again takes us back to US utility firms and then we see at 233, which is part of the point the Chief Justice is making, "The Commission considers that US electricity utilities subject to rate of return regulation are likely to be a good proxy to the TSO beta as they are subject to annual resetting of prices... that an industry effect should also be considered". Now there's a more detailed discussion, sorry, just to complete the point, on 1648, "The design of the TSO – it's 236 – "The design of the TSO funding mechanism reduces the risk faced by the TSP to below that of the Telecom fixed PSTN business," but that had a range – it took it to about 0.8, so it doesn't take Telecom's own fixed PSTN business, it goes to something lower, and here we see the breakdown I talked about before, "Based on the estimated asset beta of 0.3 for US electricity firms subject to rate of return regulation, the TSO WACC paper and the TSO Draft Determination suggested an asset beta... of between 0.2 and 0.4, with a mid-point of 0.3. 237 says, "the Commission considers that an increment to the asset beta of 0.1 warranted in recognition of a small industry effect in addition to the regulatory effect. This means –"

ELIAS CJ:

The what industry effect?

MR HODDER:

A small industry effect.

BLANCHARD J:

What is that?

ELIAS CJ:

Oh, just a small –

MR HODDER:

I think that's the point the Chief Justice is making before, to go back to paragraph 188, I think it was, that there may be something in the industry that makes it vulnerable to technology.

ELIAS CJ:

Well, except that's hardly small is it, really, and the proof of that is in the depreciation –

MR HODDER:

Quite.

ELIAS CJ:

– allowed?

MR HODDER:

Well, we accept that.

ELIAS CJ:

It's a bit odd.

MR HODDER:

Well, that's how the Commission gets to the 0.4, the point I was making in reply to Justice Tipping before, and then the detail further on it comes – if we go to appendix 5, in particular around about page 1747 –

TIPPING J:

Is this a point, Mr Hodder, before – I'm trying to keep my head above the detail at the moment, quite frankly –

BLANCHARD J:

And above the water.

ELIAS CJ:

A good policy – a good model.

TIPPING J:

Thank you, Chief Justice. Is this – do you just say that this is completely illogical and for the moment they just "drop the ball", in effect?

MR HODDER:

Yes. That is at its highest.

TIPPING J:

What is the answer to it, according to your opponent?

MR HODDER:

The answer, I think, is said to be that somewhere in this 0.4, cunningly disguised, is a large component of technological risk.

BLANCHARD J:

And you would admit that there might be a very small component –

MR HODDER:

Yes.

BLANCHARD J:

– in the 0.1 you say?

MR HODDER:

Yes.

TIPPING J:

But it's allowed for sufficiently in the 0.1 –

MR HODDER:

We assume so.

TIPPING J:

– but should not be found in a concealed way in the 0.3?

MR HODDER:

Correct.

TIPPING J:

Well –

MR HODDER:

When you have historical cost and rate of return regulation, there is no technological risk that's – the provider suffers from.

TIPPING J:

Yes.

ELIAS CJ:

But doesn't that buy back into the, or link to the –

MR HODDER:

Does it reopen the choices question?

ELIAS CJ:

Yes.

MR HODDER:

No.

TIPPING J:

Sauce and geese –

MR HODDER:

1747 is part of the appendix 5, A5, which has a more detailed discussion of the beta, but it really goes to the Chief Justice's question about why were they using overseas businesses and so A5.39 you'll see the Commission has previously – returns to the TSP may be regarded as similar in nature to the almost guaranteed returns for firms –

BLANCHARD J:

I'm sorry I've lost the place.

MR HODDER:

1747.

ELIAS CJ:

Those –

MR HODDER:

Paragraph A5.39 – sorry.

ELIAS CJ:

– beta rates of return of the US electricity utilities are largely set are they because of regulatory risk –

MR HODDER:

I'm not sure.

ELIAS CJ:

– that was one of the factors that was identified in –

MR HODDER:

There's a factor that's identified in, yes. There will be a component of it.

ELIAS CJ:

Yes. But there's not really any regulatory risk here, is there?

MR HODDER:

I think this litigation can rather suggest there might be.

ELIAS CJ:

Well there's litigation risk, perhaps, but –

MR HODDER:

Well the proposition is the Commission gets it wrong, that's all the regulatory risk means, or the regulator in the US gets it wrong.

ELIAS CJ:

Yes.

TIPPING J:

But whether that be so or not, the key dimension, as I understand the argument, is you can't logically take away something that was never there in the first place.

MR HODDER:

Yes. If you were basing on historical cost and with a guaranteed rate of return, you don't face any technological risk –

TIPPING J:

No.

MR HODDER:

– that's the point – that's just one of the factors of it and this is acknowledged in relation to these particular utilities.

TIPPING J:

Well, isn't that the nub of the point in what amount of detail –

MR HODDER:

It is.

TIPPING J:

– is going to make the point better?

ELIAS CJ:

Well if you like to understand it, you might like a little bit –

TIPPING J:

I'm not wanting to choke it off, Mr Hodder, but I'm just –

ELIAS CJ:

No, no you're absolutely right – you're responding to his point but I don't know why they are, I don't know why – well maybe it's not necessary to know, but at the moment it's not clear to me why an asset beta based on these American electricity utilities was correct anyway.

MR HODDER:

Well, I'm not sure I – the Court wants me to go through the whole detail –

ELIAS CJ:

No.

MR HODDER:

– but can I say it's set out in paragraph A5.39 on 1747 onwards is the discussion –

ELIAS CJ:

17 – ?

MR HODDER:

1747.

ELIAS CJ:

Thanks.

MR HODDER:

And they rely on Dr Lally, who is quoted at some length in paragraph A5.40. A5.41, there's rejection of PWC which for Telecom was arguing, these weren't particularly useful because they were too low, and at 5.42, the Commission says it's satisfied the differences "do not preclude the use of US electricity businesses as comparators".

TIPPING J:

The long and the short of it is surely, is whether they should have used it or not. They did use it and then they used it or adjusted it illogically.

MR HODDER:

That's our point.

TIPPING J:

That's the proposition?

BLANCHARD J:

Yes. And your inconsistency argument is really an irrationality argument?

MR HODDER:

Well, we say inconsistency's a form of irrationality, although irrationality such of, sort of toxic word, I'd rather use inconsistency.

ELIAS CJ:

Well, you could just say it was an unreasonable decision, which is a much better word to use.

MR HODDER:

Yes, well, that's correct. So just – to conclude on this point perhaps, at paragraph 352 on page 1667, there's a specific statement that says, or summary on, the network stranding due to new technology: "The risks of asset stranding are best modelled in the cash flows" – i.e. not in the beta. "The Commission will take into account uncertainty with respect to the cost and timing of the introduction of new technology." Errors will be reduced by the Commission periodically reviewing its depreciation profile. "On this basis, no provision for an increment to WACC appears to be justified", and that's an increment above the 4 percent. So I'm sorry to repeat this, but we think we got 0.3% from US utilities, we got 0.1 percent for the industry, and we're not going to get any more because it doesn't regard that there's any justification in relation to technological risk. So we then take away mobile technology and we've lost 0.2, and the Telecom complaint is where did that go, and that's sort of the essence of it.

Now there's an attempt in the 2004/05 determination which I need to refer to, which is volume –

McGRATH J:

Just before you go there, I think you did explain this earlier, but this discrepancy that you've put to us, it wasn't the subject of any opportunity to make submissions to the Commission, is that right, are you saying that this particular analysis first appeared in this determination, you didn't get it in an earlier draft determination?

MR HODDER:

No I think that, don't know if we said quite that. The Commission did signal that it was going to – I think there was a signal that it was going to do that, and there was a protest from us, which is why we criticised the rate of, US rate of return regulations –

McGRATH J:

Yes.

MR HODDER:

– and indeed the 0.1 was the sort of the salt to Telecom because originally they were going to stay at 0.3 based on the US, so in the draft it had 0.3, the final was 0.4 and that followed submissions from Telecom.

McGRATH J:

Sorry, thank you.

MR HODDER:

The other side of the equation of course, is how the Commission seeks to explain its 0.2 in 2004/05, and that requires an exploration of the determination which is in volume 2 of the case.

ELIAS CJ:

Sorry volume 3?

MR HODDER:

2.

ELIAS CJ:

2, sorry.

MR HODDER:

At tab 25. So, at page 541, beginning around paragraph 215, we see the problem being identified in the revised draft determination that proceeded this, "the Commission opted to no longer introduce new technologies (Exogenous Optimisation)... This led it to conclude that the systematic capital risk associated with the asset had been decreased". 216, "In previous TSO determinations... the Commission had undertaken extensive analysis to derive an asset of beta of 0.4". And this goes onto say, "This analysis involved a direct estimate of Telecom's beta, use of domestic and overseas comparators, and the assessment of influences and risks relating to the TSO". Now, with respect, we say when you go back and look at 2001/02, when they came up with 0.4 they rejected the use of Telecom's beta because it was a much higher range and that driving factor was quite explicitly the US 0.3, plus an industry factor of 0.1...

AUDIO STOPS: 3.06.21 PM

COURT RESUMES: 3.17 PM

MR HODDER:

So, I've probably all but covered what I wanted to say about the determination. So the complaint – sorry to restate it again, but the complaint is that the Commission is absolutely clear in its 2001/02 determination that it is coming up with a zero point beta, with 0.3 of it coming from the comparison with US electricity utilities which, because they are based on historic cost and with a guaranteed rate of return, they do not bear the risks associated with the asset optimisation and asset stranding that may occur elsewhere. Now that's – I don't think I took the Court to it, that's explicit in paragraph 195 of the 2001/02 determination. It's also said in appendix 5 at footnote 240.

The Commission is explicit that if electricity utilities are a reasonable proxy it's because asset valuation and stranding risks are non-systematic because they don't relate to betas. Having gone through all that process, the Commission then says, in its next attempt at the exercise, well actually no, that's not quite right, well it doesn't ever say it's not quite right and it never quite walks away from the US utilities, but says in fact that 0.4 contained a very substantial amount of asset stranding risk and because of that, we're going to take away half of it. In our submission –

BLANCHARD J:

Do you accept that the Commission would be entitled to say oops, we think we got this wrong and now we need to change it?

MR HODDER:

Yes, indeed, if the Commission had said, we got it completely wrong, US electricity utilities are not a relevant comparison, we just got that completely wrong, sorry about that, we're starting again, we get to 0.2, as it were, from the bottom up, then we couldn't argue about that. But there's no resiling from that, that US comparison continues to be what underpins the 0.4. Now the Commission does something else later on which it calls a "decomposition analysis", which it treats as a cross-check. But a cross-check accepts the validity of the original proposition. And the original proposition says we get most of the beta in a situation where there is no asset stranding or technological risk, and in our submission that's a simple case of unreasonableness or inconsistency which can't be justified.

So Justice Winkelmann rejects Telecom's arguments in her judgment, which is in volume 1 of the case on appeal at tab 12. Now what Her Honour does is she sets out two propositions in her paragraph 25 which is on page 400 and she says, "Telecom's arguments depend on these two propositions. Prior to 2004-2005... the Commission consistently stated that the asset beta reflects only systematic risk, and that technology risk is an unsystematic risk; and secondly the Commission's original asset beta calculation of 0.4 did not include a risk factor for technological optimisation". Now it's true we placed most emphasis on the statements that I started with in this 2001/02 determination, which go back to paragraphs 179 and 180, but it doesn't say that they only have unsystematic risks, the point that the Commission's analysis of these two is that the systematic risk is minimal.

ELIAS CJ:

0.1%?

MR HODDER:

Or some part of 0.1%, we assume.

ELIAS CJ:

Well what was in the 0.1?

MR HODDER:

We don't know. The Commission doesn't break it down any further than that. But what Her Honour does is to say at paragraph 63 on page 413, "Telecom cannot succeed if those propositions are not correct. I am satisfied," she says, "that they are not". And then what I need to do is to go through the analysis that follows from there. So in 64 she says, we're correct that technological obsolescence is consistently referred to as unsystematic, but she says "what is fatal to Telecom's argument is that the Commission also consistently identifies technology risk as having a systematic component," and that proposition we don't disagree with. The Commission has said there's a systematic component, or at least there could be. And then she sets out an extract which is relied on, which the Court's been taken to. Then she goes on at 65 to say, "But," and here she's referring to paragraph 220 of the Commission's 2001/02 determination, "the Commission also said that 'a significant part of the risk of changes... may be asset-specific and non-systematic risk", i.e. that there is some part which would be systematic, and then goes on to quote from what is paragraph 226 at the end of her – this page. "The Commission is not satisfied the systematic component... warrant an increment to the TSO beta compared to assets valued with

reference to historical cost". And, I must stress, that last point is referring to the US utilities which don't have this risk.

But Her Honour goes on at 66 to say, "There is then clear acceptance by the Commission of the existence of a systematic element," and we say that doesn't follow from what the Commission's just said. And then she said, "It was open to the Commission to maintain that investment in research and development that might lead it to new technologies related to the state of the economy". Indeed, but the point I have made to the Court is that if the economy going up means more R&D then that is actually going to have an impact on it, a TSO provider, if it's going to have a bigger risk, so it's a converse rather than a systematic connection with the economy as a whole.

Then at 67, the proposition is that, well, it's "an essentially impressionistic exercise," but it wasn't an impressionistic exercise, the Commission went in great detail up to the 2001/02 determination, including the lengthy appendix 5, where it relies explicitly on the US firm as with 0.3%.

And then paragraph 68, "The Commission expressly identified that it had netted off various factors... and then it settled on an asset of 0.4. The fact that it did not attribute a numeric value to the technology risk factor does not mean that it was not weighed in that process", well, the arguments I've been putting to you are that if it was, it was a very, very small component. And then her reasoning is, I am satisfied that it was already in there, it was removal of optimisation from the model that meant they could recover the insurance effect of the regulatory system which had already been discussed by the Commission and didn't relate to cost in any substantial way, that capital risk was reduced. A reduction of capital risk justified reduction of the asset beta.

And at 69 she says, had they shifted their position, which of course is the question claims they haven't, then they were entitled to do that. And we say in this context that doesn't follow either, but the point is there hasn't been an acknowledgment and therefore at paragraph 70, "I am satisfied that the Commission has not departed from the principles it settled upon a relation to asset optimisation and the asset beta". And so on and through 71. And so the claim is dismissed. In our submission that doesn't begin to explain the problem that we believe we have identified in relation to the change from 0.4 to 0.2, and that's the essence of the appeal. So there are some

varied questions, those are the submissions in relation to each of the three appeals and –

ELIAS CJ:

Thank you, Mr Hodder.

MR HODDER:

Thank you. I'm sorry, Ma'am, there's one other thing I meant to say –

ELIAS CJ:

Yes.

MR HODDER:

My learned friend Mr Gray raised with me the fact that I have raised with you, when I was talking about the tilted annuity table that's in the Hird affidavit –

ELIAS CJ:

Yes.

MR HODDER:

– and he points out that that's contentious as to whether it should be in the case or not. That was rejected by Justice Winkelmann as saying it wasn't of assistance – there were affidavits put in by Vodafone's experts in part in response. All I had hoped was that I was referring only to the table to show the way that two different tilts would work and that it wasn't contentious. I'm not relying on the affidavit for anything else and not asking the Court to read it. In fact my learned friend's point is I asked the Court not to read the rest of it, all I was trying to do was to demonstrate that graph which wasn't in the Commission's own work.

ELIAS CJ:

That's what I had understood you were doing.

MR HODDER:

Well, my learned friend was concerned whether he had to address you in detail on his affidavits, and I tried to –

ELIAS CJ:

No, I don't imagine we'll need to read the affidavits, we've got quite enough reading to do.

MR HODDER:

As Your Honours please.

ELIAS CJ:

Yes Ms Scholtens?

MS SCHOLTENS QC:

Your Honour, it is 3.30 almost. Was that the plan?

ELIAS CJ:

Well, 3.45 we were going to go to. Does that suit – to get underway, thank you.

MS SCHOLTENS QC:

Yes. Just while I'm getting organised, if it pleases the Court, can I arrange for something to be passed to you. May it please the Court, the Commission hopefully appears to assist the Court, and, I hope initially at least, by explaining as simply as I can what it is the Commission did. Then in terms of two of the three appeals you have competing parties that are arguing both appeals, so there may be very little that I can add to that, and that is the network modelling and new methodologies appeals. Then on the asset beta matter where my learned friend Mr Hodder and I part company, Vodafone does not appear to be taking a proactive role in relation to that appeal so that's of more interest to the Commission –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– than otherwise would be the case.

ELIAS CJ:

So you'll be taking the running on that one?

MS SCHOLTENS QC:

Yes, Your Honour.

ELIAS CJ:

Yes, thanks.

MS SCHOLTENS QC:

What I propose to do was make a couple of points in relation to the legislation and then using what's effectively a Powerpoint but without the power, just step through these pictures to illustrate what's being done, and hopefully at a high level.

TIPPING J:

You can see there's a person with a magnifying glass here –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– Ms Scholtens, that made me shudder slightly.

MS SCHOLTENS QC:

Yes, and it's rather alarming to see Christchurch's network has slipped into the sea in the middle of slide 4. I hope that wasn't my fault. But can I begin with reference to the legislation and just to make a couple of points to, in effect, support the argument relating to the extent of the Court's – the Commission's discretion on this matter of net cost. The first point is the, the contrast between how section 18 applies in relation to Part 2 matters and how it applies in relation to Part 3 matters, that is determining, in effect, what does it cost an efficient provider to provide inefficient services, so services that make no money will cause a loss. And section 18, as it appears in Part 2, is applied in accordance with section 19, which directs those people who make any decisions under Part 2, and that includes the Minister or the Commission, and any of the schedules of the Act, and that's effectively relating to the regulation of various services between competitors or among players.

Section 19 directs them not just to consider the purpose in section 18, which is in paragraph A, but also in paragraph C to make the recommendation, determination or decision that they consider best gives, or is likely to give best give effect, to the purpose in section 18. So contrast that with the Part 3 direction which is to have regard to section 18 purpose and section 19, give effect to – to the extent they

consider one of two or many choices will best give effect to. And my submission is this is consistent with the Commission's broader discretion under Part 3 in terms of the application of efficiency concepts, and because they really are, the Commission really is in a much less real-world situation. It's effectively constructing an efficient service provider in order to figure out who is a commercially non-viable customer – no one knows who is non-viable, you can't ask Telecom what's the cost of providing services to commercially non-viable customers because they have to figure out what the loss is, and then and then how much of that loss can you allocate just to the provision of the TSO services, which of course is tied up with all manner of other services. So it's not readily something that can be achieved in the real world.

TIPPING J:

Are they commercially non-viable in the real world or commercially non-viable according to the hypothesis that has to be constructed?

MS SCHOLTENS QC:

The hypothesis works out whether they are commercially non-viable –

TIPPING J:

Right.

MS SCHOLTENS QC:

– Telecom may say, no, we have a much bigger loss or a much smaller loss than that, but we're not really, well we are concerned and we've heard from Telecom about that, the Commission has, but it's focused on a loss to an efficient service provider.

Can I also just refer to the first reading of the bill that introduced the legislation, which talks about the purpose of Part 3 and I do this in, in, with respect to Her Honour Justice Winkelmann, I think, I submit that she perhaps misstated the purpose in the scheme of Part 3 and Parliament's intention in relation to Part 3 in her judgment. The – you'll find the bill itself in the Commission's bundle of authorities, under tab 1.

ELIAS CJ:

I'm not sure that I've got the Commission's bundle of authorities.

MS SCHOLTENS QC:

It's a fairly thin bundle, it's got nine tabs.

ELIAS CJ:

I haven't seen it.

MS SCHOLTENS QC:

Your Honour, I have actually quoted much of the provision that I was going to take you to in the first lot of submissions on the network modelling judgment at 15 November. On page 6, para 14.

TIPPING J:

Could you give us the Hansard reference just for those who have got it out?

MS SCHOLTENS QC:

The Hansard reference, the – in the bundle it's tab 1 –

TIPPING J:

Yes. First page.

MS SCHOLTENS QC:

– on that first page, page 91, in fact 66 – the Minister's first reading speech. Halfway down 9166, and this is the quote at paragraph 14 of my submissions, it refers to Part – he refers two-thirds of the way down to Part 3, which deals with the administration of the government's social policy objectives in telecommunications, the main object of Part 3 is to set out provisions that will enable telecommunications service obligations to be implemented and enforced. "TSOs reflect government social policy objectives to ensure certain telecommunications services are available in areas where they may not otherwise be provided on a commercial basis", and then last paragraph, oh there's a reference to sort of some negotiations that have been carried out with Telecom and to be embodied in a revised agreement, then last paragraph, "The problem in the past has been the way in which other telecommunication providers have been required to meet the costs of Telecom's Kiwi Share obligations, Telecom's Kiwi Share Obligations. The practice has been for Telecom to include a premium on the price for interconnection with its network, which was not transparent or competitively neutral. Part 3 implements a transparent and neutral mechanism to deal with contributions to the cost of telecommunications service obligations, including the Kiwi Share Obligation. Part 3 also provides for monitoring to ensure

that the obligations are met". The important points, Your Honours, is that what Part 3 is doing is making the price for interconnection or the price, sorry the price for the Kiwi Share Obligations, the social obligation, transparent and a neutral mechanism, one decided by the Commission and not by Telecom within its –

TIPPING J:

The Minister says those liking algebra will be intrigued by the formula in Part 3 –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– did that not survive the process?

MS SCHOLTENS QC:

I'm not sure, Your Honour, not being a person who's intrigued by algebra, I didn't go looking for it but I think it's – there's so many algebraic equations –

TIPPING J:

All right.

MS SCHOLTENS QC:

– I think it might still be there. Section 93 –

TIPPING J:

It's 93.

MS SCHOLTENS QC:

Thank you, my learned friend is intrigued by algebra plainly. But the point is it, it is simply intended to provide transparency and a neutral mechanism. It's not there to compensate Telecom for its actual costs, it's not there to find the lowest cost or to cap Telecom's actual costs, it's a social policy of Government and it's to be priced by the Commission and then spread among all the providers. And that, it is submitted, is what Part 3 seeks to do. Your Honours, I was going to go on to –

ELIAS CJ:

No, I think that would be a suitable time to take the adjournment.

MS SCHOLTENS QC:
All right, thank you.

ELIAS CJ:
Thank you, we'll adjourn until 9 o'clock tomorrow morning.

COURT ADJOURNS: 3.41 PM
COURT RESUMES ON WEDNESDAY 23 FEBRUARY 2011 AT 9.01 AM

ELIAS CJ:
Yes, Ms Scholtens.

MS SCHOLTENS QC:
Good morning, Your Honours. Can I just mention first that counsel have discussed how we're going for time. I anticipate I will be finished by 11.30 today and in that event, all counsel consider we could be finished tomorrow, with just tomorrow, if we broke at 11.30 today, although to be on the safe side it would be great if we could begin at nine tomorrow, if that's of assistance.

ELIAS CJ:
Yes, well I'm very grateful and that's not too inconvenient, is it, for counsel and the parties, then I'm very grateful. So we'll stop when you stop, perhaps Ms Scholtens, and we'll take a short adjournment at 10.30 for 15 minutes, thank you.

MS SCHOLTENS QC:
I want to go back to the legislation briefly. Part 3 is in two parts and I just wanted to focus on subpart 2 of Part 3, which sets the annual procedure that the Commission must follow. Not all of these provisions have been the subject of discussion so far. In the Commission's submissions on the network modelling issue, the appeal from the Court of Appeal, the legislation is discussed beginning, this part, beginning in paragraph 23 on page 9 of that submission, and on page 10 at paragraph 29, the reference to subpart 2 begins.

The timeframes that appear throughout subpart 2 are of interest in perhaps ascertaining what it was Parliament was intending but certainly we – the fact that this

is an annual procedure has some significance in a number of ways, including the approach that the Commission took to a number issues, including asset beta, which we will see. The timeframes have turned out, I think, in every case to be incredibly optimistic, as you can see. Just running the model itself takes a week. So once the inputs have been determined then they go into the computer and the computer –

ELIAS CJ:

It whirrs around for a week?

MS SCHOLTENS QC:

Runs for a week, that's why there's a week between the TSO determination for 04/05 and 05/06. They were done at the same time but it took the computer a week to come out with the number –

TIPPING J:

Is it a very old and slow computer?

MS SCHOLTENS QC:

I know, Sir, I understand it's, well certainly as at the time, it was, yes.

TIPPING J:

Yes, all right, yes, that was an uncalled for remark, sorry.

ELIAS CJ:

It's not a legacy asset, is it?

MS SCHOLTENS QC:

No, no, Ma'am, although the way things are going it will be soon. So, there is quite a distinction, I guess, between the way the Commission looks at real information and the legislation recognises that revenues from the various parties, this is real information, what revenues is Telecom getting from various services, what revenues are the liable persons getting from various services. So, the – Telecom and liable persons produce information to the Commission under section 81. It's an offence under 82 if they withhold and 85, which looks at considerations for determining revenue basis, is different from net cost. It's a much more constrained – much more constrained requirements on the Commission here, they're effectively given choices, two choices of basis.

You'll see in section 85(2)(a), they again consider the purpose set out in section 18, but in this context under (b) they choose the method the Commission considers best gives or is likely to best give effect to that purpose. So that, again, that's a reflection of the section 19 requirement on the Commission and its Part 2 obligations.

ELIAS CJ:

The section 18?

MS SCHOLTENS QC:

Section, yes, the section 19 refers to section 18. Section 19 is the one that says –

McGRATH J:

The "must give effect" provision.

MS SCHOLTENS QC:

Yes, as opposed to "have regard to" which you see in section 84(2)(c), or consider, I'm sorry, "must consider" the purpose. So it goes –

TIPPING J:

So in 85 it's simply a choice between two methods, whereas –

MS SCHOLTENS QC:

That's right.

TIPPING J:

– you're contrasting that with 84, where the point is much more at large.

MS SCHOLTENS QC:

Much more at large, and much less based on actual information. Revenues are certainly requesting particular information in particular form. The draft determination requirements, set out beginning in section 86, essentially process but there are matters to be included in section 88. They're slightly more extensive than the matters to be included in the final determination in section 92 and that reflects Parliament's intention that the draft provides the parties with information that they can then respond to obviously.

This requirement in section 83, to provide information and calculations, as you've heard, the Commission effectively tells the TSP, Telecom, what information it wants

and in what form and requires it to use its model. That obviously hasn't always – well, that hasn't been the situation and one can see that in the first determination, or in the process leading out to the first determination, where Telecom has prepared its own model and is trying to persuade the Commission that this is the best way of doing it. You can see the comparisons between the results of that in the draft determination, the first draft determination, which is in volume 3, at tab 36.

Can I just mention, this is the first draft determination. It follows itself through a very lengthy process and you've seen some of the papers that the Commission produced and some of the submissions. Of course this is not the entire record. The entire record is much more than this, and relates to a broader range of issues which are not before this Court. But this is the first draft determination, is where the Commission as a result of the process it had been through over two years, put together its preliminary view on the net cost. In discussing that it discussed Telecom's methodology, and that's found at page 1297 and you'll see there paragraph 359 on the 20th of September 2002, Telecom provided the Commission with its calculation of the net cost and it advised that it was $226.5 million, now we're dealing with a six-month period at this stage. So that was the first, then.

Then it notes that the Commission wrote to Telecom setting out requirements – there were three letters, so the requirements obviously were reconsidered at different times. Then on 8 November Telecom provided its calculation incorporating the Commission's requirements including a WACC of 8.2 percent. The result was $112 million. And then April 2003, this determination is to June 2003. April 2003, fresh calculations, some improvements, same WACC that the Commission had determined and it's $85 million. Then there's reference to the Commission's position paper on 30 September, which stated the Commission considered a bottom-up approach should be adopted for the modelling. So you'll see that compares with the 20th of September when the Commission received TSOs model, and the discussion shows that it's much more of a top-down model. Well, it is a top-down model.

And then on 25 October the Commission announced that it had decided to use this bottom-up model which I'll take Your Honours to. But it did note that Telecom's net cost calculations provided some helpful input, but its model was not the sort of model the Commission envisaged. And the outcome of the Commission's model for this period, in the end, was $38.8 million, which is on page 1229.

ELIAS CJ:

Sorry, 1 – ?

MS SCHOLTENS QC:

1229, Your Honour. This is the draft that came out with 38.8. And I think that went up a little in the final. I'm told it went to 34.7 and the final went down a little.

Can I ask the Court now to look at the slides that I, that have been prepared. The first slide is headed, "The TSO Context," and the context, I guess, well the context is of the 1.3 million lines that Telecom has, which of its owners are – which of those customers are not commercially viable, which are running at a loss on the basis that Telecom's providing it with a particular level of service as required by the Government. And the question that the Commission has to ask first is, what is an efficient set of costs to provide that service? And it's only the outcome of all the inputs that tell you how many potential lines or customers are commercially non-viable, so you finish there, you don't start there. The process effectively is to start with the operating cost, now there's some real-world information coming in there but of course operating costs in this context are very small. It doesn't cost much to – the direct costs of a telephone call, there's obviously electricity and matters like that but the primary costs are the hardware that gets the call to the, to connect between two people, the capital costs. So the operating costs are not challenged in any of these appeals. The capital cost is obviously the heart of the appeal that Vodafone had brought, and went to the Court of Appeal. And the capital cost is the result of the modelling, the primary modelling process that the Commission chose, and that included the choice of the optimised replacement cost valuation methodology. So into the capital cost go, obviously, the return of capital and the choice there was to use optimised replacement cost depreciation and with the tilt, the tilted annuity and then the return on capital, the weighted average capital cost, and that box is expanded below because it's part of the makeup of the WACC that has been challenged by Telecom. And in particular the asset beta, which is part of the equity beta. So within the WACC you have the cost of debt, and which is not challenged in these proceedings but has become one of the perhaps key issues that may be the subject of the next round. The leverage of 7030 is – it's been that way since the beginning, that's not been challenged in these proceedings. And the cost of equity is the use of the Brennan-Lally Capital Asset Pricing Model in which is fed the asset beta. And the asset beta is effectively the equity beta in the absence of debt, and it's noted there are a number of other inputs that go into the cost of equity which are not challenged. The list of inputs in the weighted average cost of capital, you can see in the various determinations after the discussion on the WACC, there's always a list

that says what the Commission's determined. There's generally a high and a low point, and they go for the median. And an example of that, I think, is on, in volume 1, tab 6 at page 136, 136.

Then, on the next page, looking now, really focusing in on the back of the green box, the asset base and the optimisation process, how was that done. Just for context, public switch telephone network, you're probably very familiar with this, but you've got effect on the right and left-hand side, the local access networks and in the middle the core network where calls can be routed a various number of ways to get between, to take a national call across the country, the local call effectively stays within the local access network. So then we talk here about local access network and the core network, each has a different model applying to it, although those models form part of the overall Commission's model which is made up of lots of little models. So you have the customer premises, equipment, which is the picture of a telephone, although it's quite interesting a four year old asked me this morning, "What is that?" And I said, "It's a telephone," and she said, "You can't draw", because that looks nothing like she thinks a telephone looks like, and it just sort of said to me well I've probably got people in my chambers who wouldn't recognise that as a telephone either, that certainly the technology has moved very quickly. And then cabinet, the telephones are connected to the cabinet, and the cabinet is connected to the exchange, which is the node. When we talk about scorched node in this context, that's the exchange, the local exchange. In other contexts a scorched node may not mean that node within this context here – this is the node we're talking about. So that node would normally have many cabinets coming off it.

So then over the page we see the model of the core network as it was in year zero, that's 2001/2002. The, what the Commission did was they looked at how the core network effectively existed now and they could see, have tier one on the left-hand side, the key exchanges, and then tier two, intra-region connections, that's the middle, middle picture and that's supposed to show Christchurch, Dunedin and Invercargill, and then you have local connections from there, Invercargill out to the exchange service area, and those exchange service areas, those square boxes you see with the cross in them, they're the nodes we're talking about. So if you scorch the node, you leave all this core network in place. So the, so the Commission's model assumed –

TIPPING J:

So you leave in place the two maps, part of New Zealand, and you take out the coloured bit in the third map, is that right?

MS SCHOLTENS QC:

That's right, Your Honour, which we'll look at on the next –

TIPPING J:

Right.

MS SCHOLTENS QC:

– page, what's in that coloured bit. So you end up with, yes, those three, the square boxes in those three diagrams remain. That network, three-tier network remains and that's the core network. It was pretty much accepted by the Commission as, as built, although there was some optimising of it. Some of the little exchanges were considered, you know, ought to be amalgamated or moved, whatever, and that was accepted and it wasn't a focus of debate. Again, limited affect on the cost, because the incremental cost of providing non-viable customers with services over a core network, is relatively small. A core network is used for everything essentially, so only a very few exchanges would be servicing only commercially non-viable customers.

BLANCHARD J:

Is the little bloke with the magnifying glass a Commerce Commission employee?

MS SCHOLTENS QC:

Must be, Sir.

TIPPING J:

But where, do you have to apportion, say you have something that's serving both viable and nonviable customers, do you have to apportion, do you?

MS SCHOLTENS QC:

That's –

TIPPING J:

Or that's the theory?

MS SCHOLTENS QC:

– that's, yes, that's the theory, yes.

TIPPING J:

Theory, yes.

MS SCHOLTENS QC:

You have to work out the incremental cost, which it's, I presume you may be well familiar with these terms, but it was wonderfully explained to me by, you've got a fridge and it's half full of beer and you want to put one more beer in it. What's the capital cost you need? Nothing, just open the door and stick the –

TIPPING J:

This is great stuff, Ms Scholtens, this is much better that Mr Hodder's theory.

BLANCHARD J:

But do you then apportion the electricity that is powering the fridge?

MS SCHOLTENS QC:

Yes, yes, thank you. I knew there was something. But if your fridge is already full of beer and you want to put one more in the fridge, you have to buy a new fridge and hook it up again and so your capital costs are much greater.

BLANCHARD J:

Just for one can?

MS SCHOLTENS QC:

Well, yes, you'll make, you'll make judgements about how much capital to spend looking ahead, but –

TIPPING J:

You might, say, want another dozen?

MS SCHOLTENS QC:

You might, yes, who knows, but yes, the incremental cost is important because obviously we're looking only here at incremental costs. We've got to disregard the costs that are already incurred in providing services to all the other customers and we also have to disregard, according to the legislation, the services to people in

outlying areas that might make, you know, that, whose lines are very expensive to get to, but they might to a lot of business on their telephone, beyond the simple cost of a line. They might make a lot of toll calls, et cetera, so you've got to add all that revenue back in because that will make them commercially viable, may make them commercially viable. So the traffic received is, the traffic and the revenues received is significant.

So that's the core network and the cost probe model was applied to this, a model that was built in New Zealand to ensure that there was a still an amount, a level of optimisation, modern equivalent assets were assumed to, to value this core network and if you, Telecom's figures would suggest that it, if you were looking at historic costs, anyone would assume that would be a lot more expensive than modern equivalent assets to, to rebuild a network. It should be made, I think it should be cheaper to do it that way. So it was optimised as a new core network, effectively following that path as at 2001.

And then the scorching, which was the Commission's primary way in which it ensured that this provision of services was efficient, you'll see from over the page, the man with the magnifying glass is blowing up one of those little green areas, so one of the exchange service areas within that sample and you see the square in the middle, there's the exchange, the red line is the connection to the core network that we saw before and there are all the customers with their little telephones. In the real world, that network has been built from the exchange to those customers over time, not necessarily in the way it would be done if you started again, so scorched, scorched node, what it does is basically bonds the area, takes out all the existing infrastructure, except the exchange node, it bonds the equipment, but it keeps the place, and the, the customers, they're left in tact.

So you've got their location, which is set and doesn't change in the model, because the legislation effectively keeps the obligation as at 2000, the number of customers there, and reconfigures that area, as it would be most efficiently built then, and to do that it uses a model which you'll see is called the Hybrid Cost Proxy Model, HCPM, it's been borrowed and adapted from the FCC. It's used, it's not an unusual model for scorching, it's, it builds a new hypothetical infrastructure that doesn't really exist. It uses modern equivalent assets to service those locations. It will, if it's, the model's told, you know, to assume that the ESA has certain topographical features, tagged with a, you know, if it's very rocky or if the soil's very difficult or clay or whatever, so

it's not exact, but it's given a tag, and then the model figures out, what's the most efficient way to service those customers, using the wire network. It may dig the wires, it may use aerial wires and, in fact, the record reflects somewhere between 20 and 25 percent of the models, the wires aren't dug into the ground, they're aerial and I think Telecom have –

TIPPING J:

But significantly it doesn't use wireless?

MS SCHOLTENS QC:

No it doesn't, its wire.

TIPPING J:

That, that's the kernel of the supposed problem, isn't it?

MS SCHOLTENS QC:

That is, yes, yes.

ELIAS CJ:

And the scorching of this part –

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

– is not in contention, is it?

MS SCHOLTENS QC:

Ah, well –

ELIAS CJ:

It's not the subject of the appeal?

MS SCHOLTENS QC:

Vo- as I, Vodafone say you need to use an overlay of mobile technology –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– and in that, what the Commission did was apply a mobile technology cap. They stuck with the ESA boundaries because of the model that they had chosen –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– so, I think it's fair to say that what Vodafone are saying is the model doesn't work any more because mobile –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– must be factored in and the way the Commission tried to factor in mobile, they said was too artificial, that's in 04. The Commission then tried to factor it in in a different way in the following year, the new, which is when they got to a point where they said, we're going to actually do this a different way, we're not going to optimise, but I will come to that, so –

McGRATH J:

But in 2001, when they said that would just be tendering, is that referring to what its impression was of what Vodafone was asking for, in relation to these links? It didn't want, the Commission didn't want to get into a tendering-type exercise?

MS SCHOLTENS QC:

Yes. But I think, I'm not sure I can take what they meant any further than what they said, Your Honour, but –

McGRATH J:

Don't worry, I'm sorry, the word, that expression, "We think this would be tendering," or something –

MS SCHOLTENS QC:

Well, yes, that's right, yes.

McGRATH J:

– appears from time to time in the various determinations.

MS SCHOLTENS QC:

That's right, it does, and I think it's partly because they see the importance of the scorched node approach reflecting some reality in terms of a return on sunk investment, compared to if you were scorching the earth completely, then you'd have no regard to that.

McGRATH J:

Yes.

ELIAS CJ:

Well, tendering would be scorched earth –

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

– wouldn't it, because it would be whatever somebody was prepared to tender –

MS SCHOLTENS QC:

Yes, yes.

ELIAS CJ:

– and it would presumably use –

MS SCHOLTENS QC:

Today.

ELIAS CJ:

– the cheapest technology?

MS SCHOLTENS QC:

Yes.

McGRATH J:

But I thought this process was meant to be the equivalent of scorched earth, between the exchange node and the customer, is that not right?

MS SCHOLTENS QC:

Yes, this is, yes.

ELIAS CJ:

And that part of it is not in contention, which is really the question I was asking you to confirm.

MS SCHOLTENS QC:

That, that the way the Commission did it, or the fact?

ELIAS CJ:

Well, I suppose the fact that you need to put an overlay necessarily does affect –

TIPPING J:

It's what you hypothetically put in its place –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– that's in contention.

MS SCHOLTENS QC:

Yes.

BLANCHARD J:

But am I right in thinking that what Vodafone is suggesting would mean abandoning the ESAs?

MS SCHOLTENS QC:

Yes, yes, Sir.

BLANCHARD J:

So it would be pretty major.

MS SCHOLTENS QC:

Well, yes –

BLANCHARD J:

That's what's hard to get a picture of.

MS SCHOLTENS QC:

Can I get – I hope that I will make that clear. There is an in-between, there's several in-between positions that don't involve the, abandoning the ESAs, but do involve modifying or relaxing the scorched earth approach, scorched node.

TIPPING J:

Can you just remind me what is an ESA?

MS SCHOLTENS QC:

Sorry, the Exchange Service Area, the green bit. So that what we scorch – I shouldn't say "ESA".

ELIAS CJ:

Because you assume the existing locations and that is what is rendered unnecessary with mobile technology delivery?

MS SCHOLTENS QC:

No, no, that's actually not any – no one disputes that you assume, even with mobile technology, you assume the existing locations of the customers.

ELIAS CJ:

Well, no, no, I don't mean the customers, I mean the nodes.

MS SCHOLTENS QC:

Oh, the nodes, no.

ELIAS CJ:

The exchange.

MS SCHOLTENS QC:

That's right. They become –

ELIAS CJ:

They become irrelevant, there's a different delivery.

MS SCHOLTENS QC:

– irrelevant, if you look at the real world of mobile technology. In the modelled world, the Commission was trying to keep them relevant.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

And then it relaxed that a little in the 05/06, or began to. So, you've got, when I say, "ESA", this is the green area which is the scorched node.

ELIAS CJ:

Sorry, 05/06, we're not dealing with 05/06, are we?

BLANCHARD J:

Yes, we are.

ELIAS CJ:

Is that the second –

MS SCHOLTENS QC:

The one, the High Court decisions, yes.

ELIAS CJ:

Oh, the High Court decision, sorry, I keep thinking of it as the 05 one, but it is actually 05/06.

MS SCHOLTENS QC:

Yes.

BLANCHARD J:

It's two years.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

Yes, and 06/07. Sorry, it's, yes, I'm confusing you, Your Honour. 04/05 and 05/06 are the two High Court ones, I'm sorry.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

So, if you turn over the page then, the HCPM model within that exchange service area, so, it sets the cabinet positions and it sets the connections to the network – yes, I'm sorry, I haven't been to that picture, have I – and you'll see within, so within each exchange service area there are what we call "clusters" and the cluster, which is modelled by the model, is around a cabinet inside the cluster. So a cluster is a group of customers around a cabinet. It's at the cluster level that most of the action happens in the model. The model is trying to figure out whether a cluster of customers is commercially non-viable or not. So, the model ignores Telecom's actual assets and models the best in-use technology, the most efficient way of building that across the area, the ESA, and has certain assumptions about each particular ESA, and I think I noted there there are 783 or 786 between the two different models which are modelled in this way. So each cluster is, goes through, the computer's iterative, it goes through and identifies – actually I need first of all – so it's, I'm sorry, start again. The model identifies the cluster and remodels the infrastructure.

Then we look at whether there is a radio cap that might be a less expensive way of providing services to that cluster, and the way that happens is, over the page, there are three caps that we are concerned about in the 03/04 litigation. So the first example on the top left there is the model with the wired technologies, as you've seen before. So you've got the box, being their exchange, the cabinet at the middle of the cluster, and then out to the various customers. Then below that you've got an example of the multi-access radio cap, and this is a technology that was used right

from the start, it appears in the 01/02 determination, because it was something that was well-developed and used by Telecom to provide service to outlying areas. So, with that radio cap you'll see you've effectively, you've got a point-to-point radio that goes from the exchange to the cabinets, so you've removed all the lines from the exchange to the cabinets.

ELIAS CJ:

Ms Scholtens, I wonder, really, I think we do have a general understanding that the model adopted, the MAR cap and the WLL cap and –

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

– we've moved on to consider the mobile technology.

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

But I'm just really wondering whether we need to get quite into this level of intricacy. Can you just tell us why you're taking us to this? What's the submission it's directed at?

MS SCHOLTENS QC:

It's really – I guess I see my role as –

ELIAS CJ:

Helping us in understanding, I – yes.

MS SCHOLTENS QC:

– to understand and, I think, understanding it is important to understanding the submissions that my learned friends are making and to understanding why the Commission struggled so much with mobile technology when it came along, and, I guess, to also show you that in terms of the efficient service provider, it didn't, it modelled the network in a way that it thought best reflected efficiency in this context, and that wouldn't necessarily cross over to a different context, but in the TSO

context, and then it also then put another layer on top of that, which was a capping layer.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

It wasn't a remodelling –

ELIAS CJ:

No.

MS SCHOLTENS QC:

– but it was a limited modelling of particular caps. And its approach was that once these were technologies, which were available and capable of providing the level of service, which was very important, that the Deed required Telcom to provide to customers, then they would attempt to model those as a cap –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– so that the TSO wouldn't get anything more than what it would get if it used these technologies.

TIPPING J:

Well, that's in effect requiring them to use them, albeit notionally.

MS SCHOLTENS QC:

Notionally, yes, Sir.

ELIAS CJ:

Or not be compensated.

MS SCHOLTENS QC:

That's right.

ELIAS CJ:

Yes.

TIPPING J:

But the ultimate submission, presumably, is that everything that the Commission did in this situation is (a) not outside the purview of the legislation, nor is it unreasonable, that's what you have to sustain, if you were a forensic party, but you're not –

MS SCHOLTENS QC:

Yes, no.

TIPPING J:

Are you going to argue or are you just laying it out for us and – ?

MS SCHOLTENS QC:

I'm only going to argue where nobody else argues.

TIPPING J:

Right.

MS SCHOLTENS QC:

Or if – and to assist, or respond, if Your Honours wish to hear from me on anything, but, yes. I am concerned, though, that it is complex and that the Court – I don't want to tell you anything you don't need to know. The mobile cap, in particular, just was difficult. It was a situation –

ELIAS CJ:

Because it's such a – was it difficult to use as a cap? It had been easier to use the MAR technology and the WLL technology as a cap, but mobile cut across –

MS SCHOLTENS QC:

It was very, it was really stretching the boundaries of the artificiality –

ELIAS CJ:

Yes, yes.

MS SCHOLTENS QC:

– because you'll see from that top, the top right diagram –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– where you've got the way, the way it was modelled in 03/04, and that was when it was first modelled, was to put, effectively, a cellphone tower by the local exchange –

ELIAS CJ:

Which is not where it would be located?

MS SCHOLTENS QC:

Well, that's right, or necessarily it could be anywhere, and then you needed to stick the relevant aerial on top of the houses wherever the customers were, and you needed to put cellphone towers effectively wherever they were needed in order to service the particular ESA.

ELIAS CJ:

And, of course, increasingly they were there, presumably, for mobile technology?

MS SCHOLTENS QC:

Increasingly, yes, although of course if you think about the real commercially non-viable customers in the real world and where they might be, there's unlikely to be too many cellphone towers serving them, particularly, to the level that – so they'd be very, they're the expensive ones.

ELIAS CJ:

So MAR is much more likely to continue to service them?

MS SCHOLTENS QC:

Yes, yes and, I mean, the level of service was important, that not a lot of the existing capability, it just simply didn't meet the level of requirement. There are three appendices to the 03/04 determination that discuss mobile and wireless technology and, you know, evaluate what Vodafone's experts were telling the Commission via

the Commission's consultants and, Your Honour, can see it's not a situation where you can say mobile technology can now, does now service a lot of customers who'd fall into this category as at 03/04 to the extent required.

I'll be very brief, but can I just point perhaps to the next –

McGRATH J:

Ms Scholtens, just before you leave, these two models, is this where we can get to understand why the term "overlay", and why it was that the Commission did not want access service costs to reflect the overlay, and that's something I don't understand at the moment, and I certainly would be assisted if this diagram, which I can follow very readily, the set of diagrams was going to explain that in any way?

MS SCHOLTENS QC:

Right, yes, Sir. The, that top right diagram doesn't take into account this overlay argument but the overlay argument is here is where cellphone towers really are, you know, Vodafone came to the Commission and said here they are. Now let's put them on top of the map of the core network and work them in. That was one argument and another –

McGRATH J:

And they, of course, already being there –

MS SCHOLTENS QC:

They already being there, yes.

McGRATH J:

– on an optimisation basis, won't have to be paid for again?

MS SCHOLTENS QC:

That's right, yes, and you'll see what the consultants made of that argument. They said, well, you can't make that assumption. That's, you know, you can't –

BLANCHARD J:

It won't fit?

MS SCHOLTENS QC:

That's right, it won't fit.

McGRATH J:

And when you say the consultant said that, that's the –

MS SCHOLTENS QC:

Gibson Quai were the consultants who evaluated the –

McGRATH J:

For the Commission?

MS SCHOLTENS QC:

For the Commission, yes, and their report is in an appendix to the 03/04 determination. So –

TIPPING J:

The overlays, as I understood it, and please, please correct me if I'm wrong, is effectively scorched earth?

MS SCHOLTENS QC:

Yes, mhm, because with mobile technology, again, I'm sure you're familiar with this but it's new to me, slide 9, doesn't, you don't need the PSTN network at all if you are calling mobile to mobile. That green line, it effectively, it goes through its own cellphone towers, through its base station controllers, which had nothing to do with where exchanges are on the PSTN, from the base station controllers to the mobile switching centres – and for Vodafone, at this time, there was one in Christchurch and one in the North Island somewhere – and through them and then back to the other mobile phone. The mobile switching centre is perhaps the key part of this network. It's the one that knows where all the cellphones are, where all the customers are, and you only use the PSTN network if you are calling between a mobile and a landline.

BLANCHARD J:

But a high percentage of calls, at least in those years, would not have been mobile to mobile?

MS SCHOLTENS QC:

No, that's right, Sir, but they still would have not, still a difficult fit with the PSTN as to what – you've got to get to the mobile switching centre before you get onto the

PSTN. That's your link and the mobile switching centre, there's only one in the North Island, one in the South Island, nothing to do with exchange service areas so it didn't fit with the scorched node model. You can see that too from the previous diagram. If you put the cellphone towers where they really are on the right-hand side, those cellphone towers, by way of example, they service all the people that are around them and they might be outside of the ESA but can handle all the calls and any of the calls within that ESA, and perhaps three of them are needed to do that, and then the red lines take them back, the calls back to the mobile switching centre and then that mobile switching centre then feeds it into the PSTN. So we've got a, two different networks.

BLANCHARD J:

You'd almost have to have two models and then somehow integrate them because of the two different types of calls, three different types of calls.

TIPPING J:

What land-to-land, mobile-to-land and mobile-to-mobile?

BLANCHARD J:

Yes, yes.

MS SCHOLTENS QC:

Yes. Yes.

ELIAS CJ:

Well, it would be capable of being modelled as a single network using the appropriate technology as required.

MS SCHOLTENS QC:

Well, they mobiled it as a cap, they modelled it as a cap –

ELIAS CJ:

Yes, but a cap isn't really the sort of approach you can adopt, which is probably really what Blanchard J is saying, a cap can't be used properly for mobile?

MS SCHOLTENS QC:

I guess, yes, if you're starting again today and it was accepted that mobile technology was a cost-effective way of doing things, of servicing these people, you might well build a different model.

BLANCHARD J:

So, in that sense, are these two, are the two subsequent years an example of an interim situation?

MS SCHOLTENS QC:

The two subsequent years are an example of when the Commission tried to model the, tried to modify the mobile cap as suggested by Vodafone's experts, and as they were doing that, you'll see from the discussions, they got to a point where they realised, well, not that they – but they recognised that there was an issue here about the impact on the return of and on capital and they looked at their options and one of their options was to not model new technology at all as a cap, and that's what they went for. There were other options too –

ELIAS CJ:

Is that because, effectively, they were only using some new technology, that accommodating mobile technology was – really, really required a new model?

MS SCHOLTENS QC:

I think they – the answer, I guess, as simply as I can put it is that when you look at their three options, one of them was to continue to do this, to continue to model new technology. It wasn't that it was, that they weren't modelling all of it. They were modelling everything that qualified. It was very difficult and it was getting more complex.

BLANCHARD J:

Were they capable of doing it? Presumably, Vodafone didn't come to them and say, "Here's a model you could use?" Vodafone, presumably, said at a more higher level, "This is what you should achieve. Go to it."

MS SCHOLTENS QC:

Now, I think, Your Honour, in this situation, the Commission very much receive submissions from the parties which included extremely detailed expert models, explanations, information. The Commission then got its experts to evaluate that.

There was much requesting of new information, clarification, but the Commission, in a sort of quasi-judicial role, was responding, to a degree, to what the parties were suggesting, so Vodafone said, "You can do this better or different", then they would attempt to persuade the Commission of that.

BLANCHARD J:

Well, was it that the Commission, in the end, couldn't do it to the degree which it thought was necessary, or was it that the Commission could do it but considered in the end that it wasn't an appropriate thing to do?

MS SCHOLTENS QC:

The latter. It was certainly difficult as well as – it considered it wasn't appropriate and of its options this was the most cost-effective one for the Commission with the same outcome.

ELIAS CJ:

Cost-effective for the Commission, what do you mean by that?

MS SCHOLTENS QC:

In terms of the time, effort, resources that the Commission would have to put into the process.

ELIAS CJ:

Regulatory costs, you're talking about there?

MS SCHOLTENS QC:

Yes, yes. That wasn't the driving force, Your Honour, but you will see that of all the options it also appeared to be the one that provided the most certainty and simplicity going forward.

So, Your Honours, that four-quarter diagram shows you that, you know, the introduction of the capping technologies in the various years. In the 04/05, which is the first year that Her Honour Justice Winkelmann is concerned with – can I ask Your Honours perhaps to have a look at what it was that the Commission was proposing, which is in volume 8 of the case. I'm sorry, it's volume – yes it is.

ELIAS CJ:

Which volume?

MS SCHOLTENS QC:

Volume 8, the draft determination, which you needn't look at but it's the first document under tab 85. It had the same approach to the modelling of the caps as previously used. There were a significant number of, usual number of, submissions in relation to the Commission's approach and, I'm sorry, it is volume 9 and so what the Commission decided to do in response to that –

ELIAS CJ:

What tab?

MS SCHOLTENS QC:

Tab 94, Your Honour. That's a, 3952 is simply the administrative arrangements for the conference. You'll see proposed agenda at the foot. Updated MT mobile technology cap, and then they refer to a refinement, selection of the ESA, et cetera. Over the page is the paper at 3954 in relation to the refinement of the cap, and it refers to the earlier drafts and refers to, then, the earlier determination, then the facts, sorry, the earlier drafts refer to the three radio caps. The fact that in 03/04, the mobile technology and Wireless Local Loop caps were more expensive than the mobile, than the Multi-Access Radio caps so they were ineffective, and that the Commission was being asked to review the cap and now it's seeking comment on that. It refers at the foot to Telecom's existing radio assets that can be used to provide service. The prices don't have to be within the ESA boundary and they can be shared, so that's different from what happened before; and then (b) the cap can use or share existing cell sites; and at (c) green-field sites necessary to provide services will have to bear the full long run incremental cost of the site.

And then you'll see on page 3956, just above the first heading, "Strata Reuse Telecom's Existing Assets," it says, last sentence, "It's planned the TSO model will have to cater for two mobile technology caps. One related to the possibility of using Telecom's assets, the other relating to the TSO modelling of green-field assets."

So that paper was sent to participants in the conference and there are significant, well, then there were a number of submissions on that. It was a submission that Vodafone was comfortable with, and supported as can be seen from tab 96. There

are some useful diagrams just to point out to, Your Honours, at 102 that show the comparisons between the copper network as, that's the first one. Just choose exchange cabinet phones and then each page compares the copper to the other networks again, so you can see the various wireless networks which would remove the infrastructure to particular points, so we've got Multi-Access Radio on 4080, Wireless Local Loop on 4081, the mobile technologies on 4082 as they were first applied, and then what was proposed on 4083 which was much more of a recognition of the existence of the existing network.

BLANCHARD J:

I notice it says "in parallel to the core network"?

MS SCHOLTENS QC:

Yes, yes, and one of the complaints that –

ELIAS CJ:

Sorry, where is that?

BLANCHARD J:

It's on 4083 in the bottom part of the diagram that the words –

ELIAS CJ:

Oh yes, I see.

MS SCHOLTENS QC:

Parallel to the core network, and one of the complaints that Telecom made was that it doesn't include the cost of switching back to the MSC –

BLANCHARD J:

What's the MSC?

MS SCHOLTENS QC:

That's the, you'll see that's the box beside the words you were looking at –

BLANCHARD J:

Yes, but what is an MSC?

MS SCHOLTENS QC:

It's the Mobile Switching Centre, those – in the diagrams there were those two, one in the North Island, one in the South Island at that time, so it's the key piece of technology and those are where all the cellphones are.

BLANCHARD J:

And there was a complaint that –

MS SCHOLTENS QC:

That Telecom said, "Well, you're not including the costs of getting those phones, those calls to the mobile switching centre." As a result of the submissions in the conference, the Commission issued a revised draft and this is where it decided it would drop the caps altogether, well, apart from the caps which it called endogenous, the ones that had existed from the beginning, which the only effective one was the MAR.

ELIAS CJ:

So did they maintain the MAR cap?

MS SCHOLTENS QC:

Yes, yes, they did and the options – can I ask Your Honours to look at the options which they set out in their draft which is in volume 10 at tab 106, the revised draft.

ELIAS CJ:

Do we have, by the way, a chronology so that if we want to follow this through, did anyone provide us with that in terms of the decisions?

MS SCHOLTENS QC:

Yes, you do, Your Honour. In terms of optimisation through the years and then what the Commission did and where you'll find it and how they applied the cap –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– that is in the appendix to the Commission's submissions on network modelling.

ELIAS CJ:

Yes, thank you.

MS SCHOLTENS QC:

And then in the asset beta appendix, you deal with 04 and 05, because asset beta was very much part of this.

ELIAS CJ:

Right, thank you.

MS SCHOLTENS QC:

That is important to remember that the Commission, of great significance to the Commission, that there were two decisions. They were – two choices it made – they were linked. They reduced the asset beta and they removed the capping of exogenous mobile radio technology, and they lowered the beta because they said, well, we've done that, we've reduced the risk that the regulator's going to get it wrong. So 13 May, page, the revised draft, page –

ELIAS CJ:

What volume?

MS SCHOLTENS QC:

Ten, Your Honour, tab 106, page 4379 at page 4401.

BLANCHARD J:

Sorry, what page number?

MS SCHOLTENS QC:

4401, Your Honour. So this is the draft, and here the Commission's responding to what the parties are telling it about new technologies. So a key issue is the introduction through the use of caps in the exercise, it says in paragraph 23, 24, there's been a range of submissions and areas of concern and obvious complexities arising out of each of those and then at 25, "In the light of the approach outlined below, the Commission does not consider it necessary to address all the matters raised. Its focus has been on whether to continue with the approach it has taken to date to the introduction of new technology to the TSO model via the wireless cap and

how it has accounted for the risk of asset stranding, which arises when a technology that is more cost effective than wire line is introduced."

So there's a significant discussion about that, and certainly I'll just, you know, acknowledge from the outset that the issue of asset stranding was intended to be dealt with largely, well, in the tilts, the tilted annuity depreciation and that was, I guess, that was the, that related to expected, what was expected by way of introduction of new technology and, particularly, in this area there's the unknowns and, well, as you'll see from the discussion of the asset beta, the unknowns were much more of a systemic risk, but here it's a, the Commission has been persuaded that, in fact, the tilts do not fully allow and take into account the optimisation process and the introduction of new technology.

ELIAS CJ:

The tilts were insufficient for optimisation. Optimisation being what was required for the efficient service provider standard, is that –

MS SCHOLTENS QC:

Yes, well, every year that, that, that now that ESA was scorched, it was optimised and so, but the depreciation, the way it worked was that whatever copper lines were now used in providing commercially non-viable customers with service were depreciated by year 3 or year 4, and if it was the sort of asset that recovery of capital was seen to be something that should happen up front because of potentially short life, then by year 4 the tilts would have been reducing or on their way down, would have recovered four years of depreciation, but they may not have – does that answer your question, Your Honour? I'm just trying to remember what it was now.

ELIAS CJ:

I can't remember what it was either so take it as answered.

MS SCHOLTENS QC:

So, at paragraph 30 on page 4402, you'll see, "The scorched node approach limits the amount of new technology capable of being introduced into the modelling" – that's because the scorched node means the core network is still, still in existence – and "in each subsequent TSO determination the core network is priced using traffic levels and a WACC applied specific to that year" optimised in 01/02. And then,

"Telecom, by arguing that the Commission has not allowed for the appropriate level of expected depreciation, is effectively claiming the Commission has not applied the appropriate tilt in its tilted annuity calculation to capture the impact of new technologies. While the original tilts adopted in the modelling were based on information supplied by Telecom... it has since informed the Commission that this tilt captured only the expected depreciation associated with the original technology – i.e. the PSTN and MAR – it did not take into account new technologies... According to Telecom, new technologies should be taken into account in the TSO modelling by providing for new tilts or expected levels of depreciation. Suggestions put forward have been..." and then they're noted there.

The Commission considered the matter in paragraph 33, and concluded there are three options, and then it lists them there, so: status quo, ex-post compensation after new technologies is introduced, or different tilts to bring forward the timing of the introduction into the model, and, 34, "Option 1 assumes the expected depreciation allowed by the Commission through its tilt already appropriately compensates Telecom for the expectation of new technologies", and 2a and 2b are only applicable if it is too low. You'll see by the final, they were persuaded that, in fact, that it was too low, and therefore option 1 was not a goer because they, in terms of the ESP, they felt they had to go with, deal with the issue.

BLANCHARD J:

Was one of the constraints on the Commission an inability to go back and revisit the earlier years? In other words, to say, "Right, we're now facing a new situation. We accept that. It wasn't foreseen in the earlier years, now let's go back and remodel the earlier years with the knowledge we now have, so that they've produced different figures which will provide the appropriate compensation." I assume that the legislation would not have permitted that?

MS SCHOLTENS QC:

No, no, Your Honour. It sort of –

BLANCHARD J:

So that's a pretty significant constraint?

MS SCHOLTENS QC:

I'm not sure anybody was –

BLANCHARD J:

Because you've been asked to change courses?

MS SCHOLTENS QC:

Yes, yes. It's an annual, it's an annual thing and you do it ever year.

BLANCHARD J:

Yes, but you're being asked to change horses because of the new technology but you're having to do that in the middle of the stream rather than going back to one bank, changing horses and then going into the stream.

MS SCHOLTENS QC:

Yes, in terms of depreciation, it can look like that, yes. There were many changes though over the years. You'll see the tilts on the depreciation were changed at one time.

BLANCHARD J:

Yes, but isn't Telecom's argument that that isn't enough? Was that what they were arguing?

MS SCHOLTENS QC:

On their asset beta?

BLANCHARD J:

No, on the tilts?

MS SCHOLTENS QC:

Well, yes, they were saying they didn't –

BLANCHARD J:

That you can't, you can't reconfigure the tilts sufficiently to provide the compensation?

MS SCHOLTENS QC:

Yes, so they were saying you either – well, what they were saying is in 2a and 2b, so 2a you compensate us with a lump sum after the new technology's been modelled, that was 2a, and you'll see they thought, well, that's going to be identical to the

outcome of not introducing any new technology and in appendix 2 they discussed that, and certainly I would ask the Court if you have any difficulty with the logic here then appendix 2 can assist. So basically the outcome would be indifferent in that situation, ex-post compensation or just don't do it. But then they also said but if we do that, well, then there are systemic risks that's captured in the beta, the asset beta would have, there would be in impact on that, and paragraph 41 says that.

TIPPING J:

Are you going to address directly the –

MS SCHOLTENS QC:

Yes, I was just going to deal with asset beta but separately.

TIPPING J:

Yes, I'm not complaining, I'm just assuming.

MS SCHOLTENS QC:

Yes I will, and then so 2b, changing the tilt in timing, and then – so that's the option in 44 of increasing the tilts, and there's a reference there to a Telecom submission through NERA and the Commission's view at the foot of page 4405, and it's in this draft, so it's, it believes some asset stranding risks were included in the original tilts supplied. Unclear about the extent to which these tilts captured the impact of the alternative new technologies. Preliminary view is that a TSO modelling approach employing the original tilts and introducing new technology may not fully provide an ESP with a reasonable return on its incremental capital. So, then it says, so in that case option 1 fails to implement the scheme in text to part 3, and the Commission's faced with choosing between 2a and 2b, and then it discusses those. You'll see at 53 it doesn't consider option 2b to be a viable solution for modelling the TSO because of the problems of practically implementing the solution proposed by NERA. The need for ex-post compensation also indicates that in practice it will operate in the same manner as option 2a –

BLANCHARD J:

Sorry, where were you reading from?

MS SCHOLTENS QC:

That was para 53 at the bottom of 4406, Your Honour, and then at 54, bottom of that page, "At best, the Commission considers NERA's example simply highlights the

problems associated with introducing new technologies into a modelling process when it is assumed that the tilt has not initially been correctly set to capture the expected level of depreciation."

I guess that's Your Honour's point. "An implication of the analysis by NERA is also, therefore that had the Commission set a higher tilt in the initial period, it could have ex ante accounted for the introduction of new technologies in the future." Then 57, it's proposing that it will no longer introduce exogenous new technologies, so that's ones that weren't there at the start. The Commission notes that it remains engaged in some level of optimisation in modelling the cost of an ESP, that is, the TSO modelling considers the current location of demand of customers, the estimates of revenue from these customers, the costs of the telecommunication solutions based on existing technologies to design and cost a virtual network that supplies a certain level of telecommunication service. As a consequence, the systematic capital risk associated is reduced, leading to the subsequent decrease in the asset beta.

Then the final, Your Honours, summarises that in shorter form. There were, again, a significant number of submissions in relation to the draft, Telecom focussing to some extent on the asset beta and Vodafone on the abandoning of modelling of mobile technologies. That brings me to the asset beta. Can I begin perhaps by saying that it is an intensely factual enquiry? Her Honour Justice Winkelmann found on the facts that the Commission had taken the risk into account, the risk associated with the regulatory process and optimising the network each year, into account as part of its asset beta from the start. It was a systematic risk and my learned friend for Telecom accepts that it was within the systematic risk category, that was an issue in the High Court but he, as I understand it, is now saying that it didn't amount to much, if anything, when the 0.4 was set so the reduction from 0.4 to 0.2 is irrational in the circumstances.

TIPPING J:

Are you saying you can't take away what was never there in the first place?

MS SCHOLTENS QC:

Yes, yes he is.

BLANCHARD J:

Then what was only there in a very small degree –

TIPPING J:

Well de minimis, then.

MS SCHOLTENS QC:

Yes, yes. Can I start with just the whole, the nature of an asset beta and how again artificial it is in this very, in this context because, I mean, the beta is a representation of a bundle of risks that an organisation has compared to the risks that are reflected in the market, so what happens to the market over the course of the year, prices overall going up or down, how the market responds to systematic situation. So in booming economies or recessions and a beta of one, as it's been explained to me and it is in the papers, 1.0, a beta of 1.0 moves perfectly with the market so if you have a company that essentially responds to system, systemic, systematic risks, just like the market does, you would have a beta of 1, 1.0.

TIPPING J:

You mean it's exactly equates wider market –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– returns?

MS SCHOLTENS QC:

Yes, thank you. Zero, a beta of zero is not influenced by the market at all, doesn't move with the market, not correlated. Now here we have a business that is the business of the ESP, providing services to certain customers, and the Commission has to figure out what's the appropriate correlation of the risk of that business with the market, that's the question.

ELIAS CJ:

Is this an exercise that has to be particularly tailored, I mean, aren't there industry standards that are used?

MS SCHOLTENS QC:

It's comparators that appear to be the key here. You look for comparator organisations –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– comparisons. The difficulty here is actually finding a comparison. I guess what, I'm, I thought I'd give you the high-level approach and then see if you wanted me to take you into what is intensely factual in detail, but the Commission in 01/02, in appendix 5 to its determination, to which my learned friend took the Court in part, set out the comparators that it was looking at and how it could estimate the beta. It, one of the persuasive comparators were these new US electricity companies. The key reason being, they were regulated on a one-year cycle, so it wasn't the fact that they had historic, it was based on historic cost, that was recognised, but one-year cycle meant that, in terms of regulatory risk in setting prices, which is perhaps one of the key risks, you're back before the Commission every year and prices are reset every year. So, if there are errors, or something happens which has an impact on the compensation of return, it can be reconsidered every year, so that was one of the reasons why the US electricity companies were a comparator, just one of the reasons, and there were others.

But, importantly, the issue of the beta being set at zero point, in the draft it was 0.3, which was the midpoint between 0.2 and 0.4, which is what the Commission came to, and then the Commission was persuaded to move it up a point, so it became between 0.3 and 0.5, so they took 0.4. No reason, except for it was the midpoint.

In the second year, 02/03, the Commission was the subject of considerable submissions from Telecom on this matter so it, it had a, had another look at the beta, careful look, and what it did was, it attempted to work out the Telecom PSTN network beta, so from the, Telecom's information, what would the PSTN network have as a beta and then from that, deconstruct that beta to the capital risk and the cash flow risk, because the cash flow risk part will seem really limited, the fact that the TSO will get paid, its compensation was very limited, and the legislation had a way of recovering from reliable persons.

So you can see that, and perhaps it's worth looking at this, in the 02/03 submissions, and perhaps if Your Honour wanted to take a break, we could do that –

ELIAS CJ:

We will take a 15-minute break at this stage, thank you, and come back to that, what volume is it?

MS SCHOLTENS QC:

It's 5, Your Honour.

COURT ADJOURNS: 10.31 AM

COURT RESUMES: 10.49 AM

MS SCHOLTENS QC:

So, Your Honours, the beta discussion in volume 5, tab 58, this is the 02/03 determination starting at page 2276. You'll see, this is a discussion in the chapter dealing with the cost of capital and the discussion of beta begins on 2776 at the top, begins with the general description of beta that's found, I think, all the determinations in one form or another.

TIPPING J:

Is this the determination of which criticism is made, or the one before it?

MS SCHOLTENS QC:

This is the one, Your Honour, oh no, sorry, this is 02/03, so my learned friend took you to the one before it, 01/02 and indicated that –

TIPPING J:

But this is the one where it went from 0.4 to 0.2?

MS SCHOLTENS QC:

No, no, this is not. This was still 0.4.

TIPPING J:

Okay, thank you.

MS SCHOLTENS QC:

But the reason that I'm taking you to this is because the Commission did a significant amount of more work –

TIPPING J:

Right.

MS SCHOLTENS QC:

– to –

TIPPING J:

No, that's fine, I just wanted –

MS SCHOLTENS QC:

– revise or to reconsider the 0.4 to see whether it was appropriate or not, and so the various factors influencing it are discussed over the next few pages, as you saw in the earlier determination that my learned friend Mr Hodder took you to. Then on page 2280, there's a discussion of the beta for that previous year and how it was arrived at, the 0.4. And that's very much a summary of what was a much longer discussion in that determination.

Then we have a new submission, a new part of the determination on page 2281, where the Commission discusses the submissions that were made on the 02/03 draft and, in particular, the concerns expressed by CRA on behalf of Telecom, in relation, on the beta itself. And in response to that, on page 2283, we have the discussion on the TSO beta for 02/03. The Commission here says, well one approach to estimating the beta for the TSP is to consider an appropriate set of comparative firms.

Actually, I just want to, sorry, take you back just to 2277, where you'll see at page, I'm sorry, at para 141, the Commission says there are effectively three sources of information for determining a beta: consideration of factors that might influence a beta, direct estimation from market data, or estimates from comparable firms. And then, so back to 2283, one approach, comparative firms. And then discusses the, Telecom's criticisms in relation to the comparators used, and I just draw your attention to the discussion that is here, which I submit responds to the submissions made by my learned friend yesterday. At 173, sorry 171 on 2284, "To explore the significance or otherwise of the criticisms of the comparators... the Commission has considered the estimation of the TSO asset beta by decomposing an estimate of

Telecom's PSTN beta into its constitutes components." The Commission believes this is an alternative approach and it represents a useful cross-check.

Now, I think my learned friend tried to read down the process that the Commission went through by saying it was just a cross-check, but you'll see that it is, by itself, a fair process of considering what the beta might be if one went down this particular track, and because the result was similar that gave the Commission some comfort.

So 173, "It is a difficult enough task to estimate an asset beta, let alone attempt to identify that part which reflects systematic cash flow risk and that part which reflects systematic capital risk. However, the importance of doing so stems from two important features of the regulatory framework: the TSO cost sharing mechanism, which mitigates cash flow risk but not capital risk, and periodic asset optimisation which 'sheets home' capital risks to the TSP." And then at 175, the –

ELIAS CJ:

Is that, the TSO cost sharing mechanism mitigates cash flow risk but not capital risk – but isn't that the, the issue, trying to factor in capital, an assessment of capital risk, so I mean, it depends on what, doesn't it, on how the regulator assesses the cost?

MS SCHOLTENS QC:

Yes, yes, I think the exercise here is a recognition that there isn't much risk associated with cash flow because of the cost sharing mechanism.

ELIAS CJ:

Yes, yes.

MS SCHOLTENS QC:

But because of the periodic asset optimisation, there is a capital risk.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

What is it? What sort of risk is it?

ELIAS CJ:

I see, yes I see.

MS SCHOLTENS QC:

Okay, so 174 discusses the cash flow risk, sees it as very little, low and then at 175, "The capital risk faced by the TSP over the current regulatory period represents the risk of unexpected economic depreciation of the TSO assets over the period, i.e. the risk that actual economic depreciation deviates from expected economic depreciation over the period."

BLANCHARD J:

What does economic depreciation mean?

MS SCHOLTENS QC:

I'm assuming that's the depreciation according to the tilted annuity, so it takes into account the tilt and, yes, so actual may be, would, the tilt's set on the basis that it's expected, for example, an asset will become redundant in so many years at a certain rate of change, but as a result of optimisation of the network, the –

BLANCHARD J:

But that –

MS SCHOLTENS QC:

– result deviates.

BLANCHARD J:

– that's an unsystematic cause, isn't it?

MS SCHOLTENS QC:

The differences between expected deviation, which is built into the tilt, and unexpected, the unknown.

BLANCHARD J:

Why would that become – why would that become systematic?

MS SCHOLTENS QC:

There is, there is a discussion about why this is, I think it's recognised that optimisation and asset stranding is largely unsystematic and built into depreciation models, and that's certainly, the Commission's intention was that that's the, that's where that risk was, that unsystematic risk was dealt with in depreciation.

BLANCHARD J:

In the tilt?

MS SCHOLTENS QC:

Yes in the tilt.

BLANCHARD J:

Mmm.

MS SCHOLTENS QC:

But it was recognised, perhaps not a focus, but that there, that those tilts may not actually, there might be unexpected matters that influence the market, in terms of downturns or booms.

BLANCHARD J:

That's why I was wondering whether the term "economic depreciation" had to do with the economy –

MS SCHOLTENS QC:

Mmm.

BLANCHARD J:

But you, you –

MS SCHOLTENS QC:

Sorry, the obvious answer and I missed it, that may in fact be what it does mean, I don't know.

BLANCHARD J:

Well, do you know?

MS SCHOLTENS QC:

No.

BLANCHARD J:

Because I don't know.

MS SCHOLTENS QC:

No.

BLANCHARD J:

Somebody's going to have to tell us what that meant.

TIPPING J:

Economic – it's economic depreciation of the assets.

MS SCHOLTENS QC:

Oh, I will.

BLANCHARD J:

Yes, but it could be –

TIPPING J:

As a result of the –

BLANCHARD J:

– effect on the assets as a result of the economy, or it could mean something different.

MS SCHOLTENS QC:

Mmm.

BLANCHARD J:

I've learnt in this case that most of the language used by economists means the opposite of what it, what an ordinary individual in the street would think it means.

MS SCHOLTENS QC:

Can you give me a minute, Sir? I'll need to come back to you on that one, Sir, but I think the important point is that the Commission was definitely recognising that most risks relating to asset stranding were dealt with in depreciation, but that there were circumstances where – and regulatory risk is one of those circumstances – where

that expected rate of depreciation may not turn out to reflect the reality. Technology may become available and well able to serve these customers in certain ways at times that were not expected as a result of some sort of systemic process, and regulatory risk is tied in with industry risk and falls within the asset beta. So that's explained in 175, but I will check the economic depreciation point.

So the net cost in conjunction with cost sharing mechanism includes an allowance for expected economic depreciation and, by definition, this allowance does not take into account unexpected depreciation over the period, and, therefore, neither compensates for nor mitigates capital risk.

And then at 176, "Before addressing the relativities between cashflow and capital components of the overall asset beta, it is first worthwhile to examine the source of capital risk faced by the TSP. Although capital risk is implicitly borne by the TSP over the regulatory period, its impact is not explicitly felt or 'sheeted home' until the asset base is optimised and prices are reset at the end of the regulatory period. In other words, the TSP bears capital risk because the asset base is periodically re-optimised by the regulator in an attempt to mimic a competitive market. Accordingly the underlying sources of capital risk include not just demand, technology and cost shocks (which competitive firms face) but also possible errors by the regulator in implementing the optimisation process", and then, "If instead the existing asset base was not subject to optimisation and new capital expenditure was automatically included into the asset base at cost then, given the TSO cost sharing mechanism, the TSP would be entitled to a guaranteed return of capital, subject only to the default risk of liable persons and the risk of a change in the regulatory framework. In this case, the TSP would bear almost no capital risk. However this would conflict with the efficiency objectives of the regulatory framework as there would be the potential for gold-plating and for the TSP to earn returns on stranded assets, with the risk of this being borne by liable persons."

BLANCHARD J:
But regulatory risk is unsystematic isn't it?

MS SCHOLTENS QC:
Ah, no, it's systematic, Sir. It's treated as systematic.

BLANCHARD J:

Why?

MS SCHOLTENS QC:

I don't know. I guess, no I don't know and this is a -

BLANCHARD J:

It doesn't sound systematic.

MS SCHOLTENS QC:

No it doesn't.

BLANCHARD J:

It's got nothing to do with markets.

MS SCHOLTENS QC:

I don't know why it is, Sir.

BLANCHARD J:

Well, again, I think we need to –

MS SCHOLTENS QC:

I will come back to you on that.

BLANCHARD J:

So you're saying that regardless of why it is, here they're treating it as systematic risk.

MS SCHOLTENS QC:

Yes, absolutely.

BLANCHARD J:

Curiouser and curiouser.

MS SCHOLTENS QC:

So, all the factors that appear as systematic risk factors on 2277 are the sorts of things that are influenced by a regulator setting, that sets prices. Presence of prices or rate of return regulations listed there as a systematic issue –

TIPPING J:

Is it perhaps treated as systematic because it's not unsystematic? In other words it can't be eliminated by diversification.

BLANCHARD J:

Well, yes, it could be.

TIPPING J:

Well, it could be in theory but in this particular situation there's no diversification escape is there?

BLANCHARD J:

But you could invest in something else.

TIPPING J:

Well you could theoretically, but maybe this is the nub of the problem. What's the simple answer to Mr Hodder's complaint, Ms Scholtens?

MS SCHOLTENS QC:

The simple answer is that the Commission looked at the asset beta carefully and took a very rational approach to the estimation of something that is inherently difficult to estimate –

TIPPING J:

But that doesn't quite address the complaint.

MS SCHOLTENS QC:

Well the complaint is 0.4 to 0.2, without saying where the 0.2 was included in the first place.

TIPPING J:

Ignore the de minimis part of it. He's saying that you've taken away something that was never there in the first place and that's irrational. Now have you done that or have you not done that?

MS SCHOLTENS QC:

No, I'm saying it was there in the first place. You won't find it listed as –

TIPPING J:

You'll say it was –

MS SCHOLTENS QC:

– point, as 0.2 –

TIPPING J:

So the answer is it was already there.

MS SCHOLTENS QC:

It was already there, and this is a description of it that I'm taking the Court too.

MCGRATH J:

But the Commission wasn't explicit that it was there. Is that what you're –

MS SCHOLTENS QC:

Well, it didn't list the factors that made up the beta, no. You won't find a list that says "risk of optimisation bringing new technologies earlier than expected".

MCGRATH J:

Yes, yes.

MS SCHOLTENS QC:

Or making the depreciation profiles wrong.

ELIAS CJ:

But how does it justify the reduction?

MS SCHOLTENS QC:

Well that –

ELIAS CJ:

Without doing that.

MS SCHOLTENS QC:

It removed the regulatory risk related to optimisation, not altogether, 177 is talking about what would happen if it removed it altogether, it would go down to zero almost.

It retains still some level of optimisation and that's why it's saying – here, in 01, 02, 03, the Commission's saying, without optimisation there's no risk, no real risk to capital, and then in 04/05 it's saying, we are reducing the risk that you won't get the right rate of return on capital by making the model much less subject to unforeseen matters, which we would then have to compensate you for somewhere else.

TIPPING J:

So you're saying that they, all they were doing was really adjusting the degree of optimisation?

MS SCHOLTENS QC:

In, ah, yes, that's right.

TIPPING J:

So it's not a qualitative change, it's a quantitative change. Sorry, that's a bit elusive. In other words, they weren't taking out something that was never there in the first place. They were simply adjusting the amount of something that was already there.

MS SCHOLTENS QC:

Yes, yes.

BLANCHARD J:

Well I understand that argument, but I don't yet understand the rationale.

MS SCHOLTENS QC:

For the reduction from 0.4 to 0.2?

BLANCHARD J:

Mmm, well I don't understand the rationale of the same regulatory risk is within the asset beta –

MS SCHOLTENS QC:

Well it certainly –

BLANCHARD J:

– as a systematic risk. I'm sorry, I'm probably just being a bit dense.

MS SCHOLTENS QC:

I think it's a very good question and I can't explain it, Your Honour. It's just treated as such, and nobody's challenged that.

BLANCHARD J:

Well if you can demonstrate that it was treated as such, then whether it should have been or not, there is something there to correct.

MS SCHOLTENS QC:

Yes, and as I understand from the analysis, other regulators always treat regulatory risk as part of the beta. That mark –

BLANCHARD J:

Do they?

MS SCHOLTENS QC:

Well that's – the discussion would indicate that. Whether that's right or not, though, I don't think is an issue in this case.

TIPPING J:

Well the argument against you doesn't seem to be that they've miscategorised it –

MS SCHOLTENS QC:

No.

TIPPING J:

– it seems to me that there was no rational reason for reducing it.

MS SCHOLTENS QC:

Yes, we should have made it higher or at least kept it the same. I mean, Telecom was always arguing that the asset beta should be higher because of the technology risk and what they called technology risk. What the Commission's response was, technology risk is built into depreciation return on capital but acknowledging that there was still a residual regulatory risk in that optimisation process.

BLANCHARD J:

Well if it was there, the argument for irrationality or unreasonableness becomes much harder to make.

MS SCHOLTENS QC:

Yes, indeed. So the risk is certainly treated as systematic. In 02/03, the determination you're looking at, there was a discussion of the connection of this capital risk with that optimisation process. And then in 04/05, where the concern is the change to that optimisation process to drop out new technologies, which results in a reduction in this risk. 177 indicates, if you got rid of all optimisation, you'd have no risk. The Commission says, in 04/05, it's reduced. There is still some risk. There is still some optimisation but they've taken it down to 0.2. Nowhere will you find an analysis of the percentages. This is very much an exercise that is impressionistic, I think is the word Her Honour used in the High Court, but it's impressionistic against a lot of information and checking as best as could be done in this artificial world.

And just to finish this discussion on this 02/03 determination, at 178, para 178 on page 285, the Commission's approach, with respect to the return of capital, is to ensure the TSP has the expectation of a full recovery of the cost of prudent investment. So that's the NPV=0 or financial capital maintenance rule, and it's an expectation, it's not a guarantee. And then it says there, "In particular, tilted annuity depreciation is used to determine the expected economic depreciation in the current period."

BLANCHARD J:

Well there economic depreciation isn't being used in relation to the economy, so –

MS SCHOLTENS QC:

No.

BLANCHARD J:

– I suspect that it wasn't in 175 either.

MS SCHOLTENS QC:

No, Your Honour. I'll find out in what context they're using it. Expected economic depreciation is reflected in the cash flows, but unexpected depreciation, i.e. capital risk, is not. The extent to which the TSP bears systematic capital risk should therefore be taken into account in determining the asset beta of the TSO. Now it doesn't say 0.2 worth of it, but you see, reduce the risk, you get down to zero. So a good part of the 0.4 reflects the systematic capital risk. And to reduce it in half as a result of reducing the risk in future is, as is submitted, well within the area of judgment that the Commission can apply.

TIPPING J:

Is there any evidence before the Court, properly before the Court on this issue? Is it worth setting out an evidential foundation for Mr Hodder's challenge, or you'll re-join it?

MS SCHOLTENS QC:

I'm reflecting what's in the documents and –

TIPPING J:

But in support of the irrationality challenge, one can look, of course, to the documents as we're doing but –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– all I'm enquiring is was there anything in the affidavits in supports of the –

MS SCHOLTENS QC:

There are expert views over these.

TIPPING J:

And I suspect they'll be views in all directions?

MS SCHOLTENS QC:

Yes, both ways and also expert reports that were before the Commission, same experts in most cases. Yes, but on both sides.

TIPPING J:

All right. There's nothing you specifically want to draw attention to in the evidence, so far as the –

BLANCHARD J:

In the admissible evidence.

TIPPING J:

The admissible evidence.

MS SCHOLTENS QC:

Well, in the end Her Honour did not find any of it of assistance, and I don't believe she –

ELIAS CJ:

Well she didn't admit it.

MS SCHOLTENS QC:

No. Well, yes, on that basis, yes.

TIPPING J:

All right, that's fine.

MS SCHOLTENS QC:

No, but I certainly submit that the Commission's view is supported by information you will find in the report, most of it footnoted to expert reports that are argued by police.

TIPPING J:

Right, thank you.

MS SCHOLTENS QC:

But the important point is, and what my learned friend is saying, is the Commission has been inconsistent because in the early years it never considered this risk of optimisation as having any effect whatsoever on the asset, or minimal effect, whereas here in 02/03 they're explicitly recognising that it has the most, well, a very significant impact. And –

TIPPING J:

So you say there's no foundation for the premise of inconsistency?

MS SCHOLTENS QC:

That's right. So the matter is summarised then at 2289 down the foot of the page, this is, we're still in the 02/03 determination, at para 195. It refers to the previous asset beta of 0.4 and the criticisms of what the Commission's done, and found that a range of PSTN asset betas from 0.5 to 0.8 produces a range of TSO asset betas in between 0.30 and 0.59, or 0.34. And using the Commissioner's approach to the various parameters, this range is consistent with the asset beta used by the Commission in 01/02, as well as its draft. And then at 198 it concludes that – it notes that it's used an alternative approach to derive the asset beta, considered both approaches produce a range which are generally consistent, and at 199 an approximate point estimate of 0.4.

Now, just briefly, Your Honours, the submissions for the Commission on the asset beta approach have an appendix which just takes Your Honours through the key points in each of the determinations and the – I'll sort of skip over the 03/04 and then we come to the ones subject to appeal before Your Honours, and I've summarised the Commission's approach in the appendix at page 27 under heading D.

ELIAS CJ:

Sorry, what – I was looking at your submissions, but it's not the submissions you're referring to?

MS SCHOLTENS QC:

It is, Your Honour, the submissions on the asset beta, page 27.

ELIAS CJ:

Yes, sorry, asset beta, yes.

MS SCHOLTENS QC:

And the reference to the – it begins with the reference to the draft, which we looked at in terms of the new technologies issue. The final, sorry, the revised draft, discusses the approach to the asset beta over the years. Your Honours have seen that, and I'm not sure whether I need to take you back to it. It begins at page 539 of

volume 2, tab 25 and following, where effectively the Commission summarises its approach in the previous years and explains that as a consequence of its decision –

BLANCHARD J:

Can you give us a page number again?

MS SCHOLTENS QC:

It starts at 539, Your Honour, just over halfway down, the asset beta. So, you've got the general description going over onto 540. A reference to the revised determin – revised draft determination at the foot of 540, which is when this proposal to cease to model the exogenous new technologies, radio technologies, was raised.

You'll see the connection in para 215, at 41 in particular, in the revised draft the Commission opted to no longer introduce new technologies due the significance of technology risk in telecommunications. The removal of this risk was, in the Commission's view, likely to have a significant impact on the appropriate beta value using the cost of capital determination used in the – and then it refers to the previous analysis. Now, my learned friend did refer to the paragraph and said, well, it didn't, the Commission didn't involve, ever give a direct estimate of Telecom's beta. I think the reference there should probably be to the PSTN beta that we've just looked at, the analysis that they did.

TIPPING J:

Your submissions, paragraph 68, on asset beta, set out the essence of the argument against the Commission's view, then you're followed by some submissions that other people made, and then 74, you stuck to your guns –

MS SCHOLTENS QC:

Yes, but the other people were supportive, Your Honour. You'll see at 71 a reference to –

TIPPING J:

So are you in effect adopting, as justification for the Commission's stance, the proposition set out in 71 and 72 and 73?

MS SCHOLTENS QC:

Well, you'll see they are consistent and all this is, this is not a submission, it's a summary of what happened, and I think if you look at the determination itself you'll see how the Commission reasoned. But Professor Bowman, at 71, his views were –

TIPPING J:

Is this in support – this material is alluded to in support of the proposition that there was a respectable basis for the Commission to come to the view it did. It wasn't irrational, or unreasonable?

MS SCHOLTENS QC:

Yes, yes.

TIPPING J:

Yes, that's rather what I thought. No, that's fine, thank you.

MS SCHOLTENS QC:

So the Commission's discussion goes over 542, the first of Telecom's submissions, 543, other liable persons submissions and 545 sets out its view. It recognises its thinking has developed over the course of determinations, however, always done its analysis under an umbrella of a consistent set of principles, and then talks about the risks that are captured. There will always be systematic capital risk associated with new technologies, and para 236 refers to Professor Bowman's report there, and he was an expert for TelstraClear and Vodafone.

BLANCHARD J:

There's no reliance on the categorisation of regulatory risk. This is all the idea that if the economy is bowling along, then there's likely to be more new technology coming into the market.

MS SCHOLTENS QC:

Yes, yes, that's right. It's the risk of optimisation for new technology, so perhaps the risk is what happens when the regulator optimises for the new technology. The new technology is the systematic risk. So, the Commission then –

ELIAS CJ:

On the, sorry, on the asset replacement approach to valuation of assets, that optimisation, you weren't optimising for new technology, however, were you, under this model?

MS SCHOLTENS QC:

The capping, the cost.

ELIAS CJ:

It's just the capping?

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

Which only applied to the –

MS SCHOLTENS QC:

Everything.

ELIAS CJ:

– nodes, outwards?

MS SCHOLTENS QC:

Yes, that was a significant –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– cap, it meant if there were new technologies that provided the service cheaper than the optimised wired approach, then those new technologies – Telecom would not recover any more than the modelled cost of the new technologies.

So then there's a description of what it has done in the past, at 551. At 257, it considers that an asset beta of 0.2, though unusual in practice, is appropriate due to the hypothetical nature of the TSP asset. The asset beta of 0.2 captures the residual risks remaining from the endogenous optimisation process.

Finally, its conclusion on 552, at 262, para 262, the only difference between this determination and previous determinations are that the circumstances surrounding the optimisation process used have changed. The Commission has accounted for this in a manner that is consistent with its previous determinations. The difference in outcome in this case is due to a consistent application of well-stated principles to a different set of facts.

Now, Your Honour, I'm almost finished. There are a couple of points that I would like to check and come back to you on, but I am almost finished, so I think we're doing very well for time.

ELIAS CJ:

All right. So you don't want to carry on and conclude, I probably have –

MS SCHOLTENS QC:

Well I was, I did want to check the questions that have been asked of me, if that's –

ELIAS CJ:

That's fine. Yes, well, thank you. We'll time the adjournment now and we'll resume tomorrow at 9 o'clock. Thank you very much counsel.

COURT ADJOURNS: 11.28 AM

COURT RESUMES ON THURSDAY 24 FEBRUARY 2011 AT 9.00 AM

ELIAS CJ:

Yes, Ms Scholtens.

MS SCHOLTENS QC:

May it please the Court. I wanted to briefly address three questions from yesterday and, in the course of addressing those, just complete the submission on the asset beta and, once that's finished, very briefly address the question of law issue, the scope of the question of law issue. So in the three questions I'm looking first, at His Honour Justice Blanchard's question about economic depreciation, what does "economic" mean, and deal with that fairly shortly, and, secondly, the question about why is regulatory risk a systematic risk, or treated as a systematic risk in the asset beta and, thirdly, to go back to His Honour Justice McGrath's question from the other

day about what is meant by tendering, mimicking a tendering process when you're using an overlay mobile network.

So, the issue of "economic depreciation", that was the term that was used, and we were looking at it in the 02/03 determination in the context of the Commission considering whether their earlier estimate of an asset beta of 0.4 was appropriate. And the short answer – and I can't take you to a particular place in the record, but you can see that this must be so – is that it relates to the economic model. We're talking about the economic life of the asset, so it's economic depreciation and not accounting depreciation or…

TIPPING J:

You mean real depreciation, rather than the theoretical accountancy figure?

MS SCHOLTENS QC:

Well, it's a different theoretical depreciation, Your Honour.

TIPPING J:

So it's still –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– theoretical but on a different premise.

MS SCHOLTENS QC:

Yes, it's not accounting depreciation, and it's not, I guess – it's essentially depreciation, based on what is the question, and in 01/02, the 01/02 determination, the Commission looked at the different ways they could depreciate the life of the asset, and that's at – I don't know if it's helpful to go to that, I can do that, it's in volume 4, tab 48, page 1622, and it's useful to go to this first determination, because that's where the Commission's really setting out the approach that it's decided to take to some of these fundamental things. So depreciation's discussed, beginning at 1622 at para 109, and you'll see that it explains what methodology, what the purpose of its methodology is in 111, want to select one that enables NPV=0, the provider to break even, and it discusses in 116 three possible alternatives to determining asset

lives: those used in Telecom's accounts, the expected physical asset lives back-based on engineering specifications, and the estimates of the economic lives. And then it talks about economic lives as being, on page 1624, beginning at para 122, and this is the approach it decides to adopt at the time. So it's the, how long the asset is effectively going to last before it's no longer any use, because new technology, for example, might take over. So it may still be perfectly good and capable of doing what it's always done, but its economic worth is at an end, so you would replace it. So that effectively what the Commission's done is sort out, work out the economic lives of the assets, which they say is another matter that involves a degree of subjectivity, but they explain how they do it there, and then they look at the rate of change and the replacement cost as part of the tilt, and that's a discussion that begins on 1625. So that when they talk about the economic depreciation they're simply talking about the fact that it's depreciation of the economic life of the asset in this model.

Why has the Commission treated the risk associated with regulatory process, and I use that in a, that's a very general sense, been treated as systematic risk when it, you know, you might argue, isn't it in fact a diversifiable risk? There's no short answer to that either. They've done it from the start, they explain it in this same, 01/02 determination, in volume 4 at page 164 – that can't be right –

ELIAS CJ:

16 –

MS SCHOLTENS QC:

Sorry, 16 – I haven't got enough numbers – must be 1644, yes. In fact, it begins, I'm sorry, at 1641. Well, it begins earlier, but at 1641 in para 196, they explain the matters that go to determine the TSO asset beta. There's three of them, and they're all, they all touch on the regulatory risk, what one might broadly call "regulatory risk", because they talk about the risk associated with variables and revenues and costs, the systematic risk associated with the process of resetting costs and the discount rate at the end of each year, which of course is something the Commission does, and then the risk associated with reoptimising existing assets. And then they talk about those particular risks in the pages that follow. So certainly they've treated the matter that we're talking about as a systematic risk, although it certainly, in terms of the risk relating to the reoptimisation of assets, as you can see, they saw that as small because they considered that it was largely dealt with in the tilted depreciation. So,

in those tilts Telecom had estimated the economic life of the asset, taking into account that new methodology was likely to replace it at a certain time, and the –

ELIAS CJ:

And they accepted Telecom's figures on that, they said, didn't they?

MS SCHOLTENS QC:

Yes, they did. And Telecom did keep coming back on this point, saying, you know, you need to change the depreciation, changes the tilts, because of new technology coming in, and the Commission's response right up until the later technologies was, "Well, you know, we think this risk is included, it's already covered in the tilts, and the reason why we were persuaded that it wasn't," they were, ultimately, persuaded that it may not be, in 04/05, because Telecom said, "We only considered replacement assets relating to what was known at the time, MAR and future", what would happen with the market with the assets they were using, or optimised versions of the assets they were using, and they didn't consider the implications for mobile, for example, technology, satellite technology, those sorts of things, and that's when the Commission formed the view eventually that they may not have a model which allows break even, NPV=0, and so that's why they looked at changing, for example, the depreciation rates, and ended up deciding not to further optimise new technology into the model.

The best explanation in the record for why the regulatory risk is considered a systematic risk is in Professor Bowman's evidence to the Commission, it's not an affidavit in the proceedings, it was to the Commission just before their, their 405 determination, and we yesterday looked at the fact that the Commission referred to his evidence and the evidence of Professor Guthrie on whether 0.2 was a reasonable, reducing the beta 2.02 was a reasonable response to their decision not to model new technology, and they took heart from the fact that these experts in this area thought this was an appropriate approach and followed a thorough analysis, thorough and careful analysis, and we can see Professor Bowman's views on that in volume 11 at tab 117m and he also explains, perhaps as clearly as it can be, why this is a systematic risk.

TIPPING J:

Is he talking there of both systematic risk and the justification for taking it down from 0.4 to 0.2?

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

Sorry, what volume?

MS SCHOLTENS QC:

It's volume 11, Your Honour.

ELIAS CJ:

And the page?

MS SCHOLTENS QC:

Tab 117.

ELIAS CJ:

Yes, thank you.

MS SCHOLTENS QC:

And he sets out his qualifications and experience, but at 1790 –

BLANCHARD J:

4790.

MS SCHOLTENS QC:

Sorry, yes, thank you, Sir, 4790. About paragraph 22, he refers to the Commission's views and what the Commission's decided to do in 23. At 24 what he's been asked to provide his opinion on – and this is in fact for TelstraClear and Vodafone, this submission of VS to the Commission – at 29 he talks about portfolio theory and I guess this is, I think it was Your Honour Justice Tipping, who said, well it's a systematic risk because it's not non-systematic, and I guess that's what he's saying in para 29, but then he does go on to discuss that further. In 31 he talks about firm characteristics that provide an indication of sensitivity to unexpected changes and real GNP, which he says is a significant factor of systematic risk. And you'll see the nature of the regulatory regime is one of those and then, and then he discusses the risk of loss from optimisation through from paragraph –

TIPPING J:

Is this, putting it very simply, what he's saying is, as I understand it, is that if you invest in the share-market, the wider the spread, the less the risk. But there's still risk in investing in the share-market.

MS SCHOLTENS QC:

I'm not sure if he's, I don't know, Sir, if he's saying that. I mean, that would seem, that would seem right.

ELIAS CJ:

I think she's moved on.

TIPPING J:

Oh, I'm looking at paragraph 29.

MS SCHOLTENS QC:

Oh, 29 yes.

TIPPING J:

Sorry, sorry Ms –

McGRATH J:

That ultimate risk is non-diversifiable, yes.

TIPPING J:

Yes, you can't diversify, other than going out of the share-market.

MS SCHOLTENS QC:

Yes.

TIPPING J:

And you can no doubt reduce your risk –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– by going out of the share-market, but that's not the point.

MS SCHOLTENS QC:

Yes, yes, put it under your bed.

TIPPING J:

Exactly.

MS SCHOLTENS QC:

Yes, that's right, Sir.

TIPPING J:

In today's world, even that may not be very safe.

MS SCHOLTENS QC:

No. You might want to reassess the risk associated with that in the light of things that have happened afterwards. So 34 to 37, I guess, is a focus more on the particular risks that apply to the TSP that might be said to be systematic and why they are related to the state of the economy, and I point to that, I don't think this is important at all, but it's an explanation of why it's treated this way.

TIPPING J:

Where does he talk, Ms Scholtens, he recites in 23 the Commission's reduction from 0.4 to 0.2, just as a point of narrative –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– does he go on to say that he agrees with that or –

MS SCHOLTENS QC:

Yes, he does at the end, Sir.

TIPPING J:

Does he, and –

MS SCHOLTENS QC:

38 to 40.

TIPPING J:

38 to 40, sorry, I'm jumping ahead.

MS SCHOLTENS QC:

In 41, and I think it's 38 to 41 that the Commission in its determination it refers to, as supporting their view.

TIPPING J:

It's rather watered down by his statement, he hasn't been asked to consider it, he's just, what does he say, "I've not been asked to estimate the appropriate beta, and I've not conducted a study," but instinctively I suppose what he is saying is it looks fair enough?

MS SCHOLTENS QC:

And Your Honour will –

TIPPING J:

He isn't addressing the specific argument that's put against it?

MS SCHOLTENS QC:

No, the Commission refers also, when they are looking at it, to Professor Guthrie's approach and I think that is more –

TIPPING J:

Is that more helpful, is it?

MS SCHOLTENS QC:

I don't recall now, but I presume it must be because the Commission says it supports their approach in the 04/05 determination, in para 258. But I mean, in the end, the nature of the task is obviously very difficult and you can see that from the studies that have been done.

TIPPING J:

But you aren't able to refer us to anything, you're facing a challenge of irrationality or unreasonableness –

MS SCHOLTENS QC:

Yes.

TIPPING J:

And you've referred us to Professor Bowman –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– and you're not able to refer us to anything else that tends to rebut that challenge in the evidence, either in Court or before the Commission.

MS SCHOLTENS QC:

The –

TIPPING J:

I mean, I'm just enquiring, Ms Scholtens –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– because this absolutely central to the –

MS SCHOLTENS QC:

In terms of the reasonableness.

TIPPING J:

– asset beta issue.

MS SCHOLTENS QC:

Well, the Commission relies on its approach over the full period.

TIPPING J:

But it might be irrational over the whole period.

MS SCHOLTENS QC:

Yes, but when you look at –

TIPPING J:

But what is, what is said against you is the premise –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– you will have heard it, that it was irrational to, never mind whether the starting point was right or wrong, it was irrational to reduce it in half.

MS SCHOLTENS QC:

Yes.

TIPPING J:

Because it was never there –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– to be reduced in the first place?

MS SCHOLTENS QC:

Right, yes and my argument, the Commission's argu- the submission is that in each year, 0.4 was a reasonable asset beta supported by the evidence that the Commission had before it.

TIPPING J:

Well, let us assume that is so.

MS SCHOLTENS QC:

Yes.

TIPPING J:

Why was it reasonable to cut it in half in the year in which that was done, against the argument that's raised against you?

MS SCHOLTENS QC:

Then, there's nothing more than the analysis you will find in the determination that this is a reasonable response to ceasing to model new technology.

BLANCHARD J:

It changed the regulatory risk.

MS SCHOLTENS QC:

Yes, it lowered it significantly. By how much is an impressionistic exercise and you've seen –

TIPPING J:

That presupposes that there was regulatory risk in the 0.4.

MS SCHOLTENS QC:

Yes.

TIPPING J:

That's really the stance you have to take, isn't it?

MS SCHOLTENS QC:

Yes, yes.

TIPPING J:

And it was reduced.

MS SCHOLTENS QC:

Yes. It's fair to say in 01/02, the Commission thought the regulatory risk was minimal.

TIPPING J:

Yes, well, that's what's raised against you.

MS SCHOLTENS QC:

Yes.

McGRATH J:

But the – doesn't the position that when, in later years –

MS SCHOLTENS QC:

Yes.

McGRATH J:

– criticisms were advanced by Telecom –

MS SCHOLTENS QC:

Yes.

McGRATH J:

– the Commission looked at other approaches.

MS SCHOLTENS QC:

Yes.

McGRATH J:

It deconstructed Telecom's –

MS SCHOLTENS QC:

Yes, that's right.

McGRATH J:

– the TSO beta.

MS SCHOLTENS QC:

That was in the following – yes, Sir, in the following year.

McGRATH J:

It looked at other approaches.

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

It deconstructed the impression.

MS SCHOLTENS QC:

Yes, well, it came up with a more informed impression.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

Yes. It's still an impression –

McGRATH J:

And the –

MS SCHOLTENS QC:

– of risk, it's still looking forward, what's the risk of an earthquake in Christchurch, you know, it's still looking forward and –

McGRATH J:

But this was in subsequent years to the year I think Mr Hodder has focused on?

MS SCHOLTENS QC:

Yes, it was.

McGRATH J:

Which was 2001/2002.

MS SCHOLTENS QC:

Yes.

McGRATH J:

Now, can I just ask you this, that Professor Bowman's matter is just another strand, if you like –

MS SCHOLTENS QC:

It is, yes.

McGRATH J:

– in the matters that influence the Commission?

MS SCHOLTENS QC:

Yes, that's right, Sir.

McGRATH J:

And I may not be justified – this is my impression, not perhaps of quite so much importance as the alternative approaches to its original US –

MS SCHOLTENS QC:

Yes.

McGRATH J:

– utilities approach.

MS SCHOLTENS QC:

Yes.

McGRATH J:

It was more those other approaches that led the Commission to believe it was still on the right track.

MS SCHOLTENS QC:

Yes.

McGRATH J:

And ultimately got it to a position of thinking 0.2 was on the right track.

MS SCHOLTENS QC:

That's right, yes, Sir.

McGRATH J:

Well, that's where I'm at with what you were saying the day before yesterday.

MS SCHOLTENS QC:

Thank you, yes.

McGRATH J:

It seems a long time ago.

MS SCHOLTENS QC:

Thank you. And then that does remind, the other very important thing in relation to my learned friend's argument is that, yes, 01/02, it thought it might be dealing with a minimal risk, it also thought that the depreciation methodology had captured most of the risk. When it went, in 04/05, it had changed its view of that, it had decided, "No, the depreciation methodology with the tilted annuities actually doesn't capture as much of the risk as we originally thought, and that's because it was persuaded by Telecom's argument on that.

TIPPING J:

So they persuaded you to do the thing they're now complaining about.

MS SCHOLTENS QC:

They didn't ask us to reduce the asset beta.

TIPPING J:

No, no, but that was the premise –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– on which you –

MS SCHOLTENS QC:

It was, yes, that's right, they didn't agree that that should follow.

TIPPING J:

Oh, I know, they didn't say, "And as a result, reduce it."

MS SCHOLTENS QC:

No.

TIPPING J:

You say that is the foundation, or a substantial plank –

MS SCHOLTENS QC:

That's right, yes.

TIPPING J:

– in what you did?

MS SCHOLTENS QC:

That's right, and we say it's a plank the Commission signalled right from at least 02/03 in the passage I took you through yesterday, and certainly – sorry, yes, 02/03. And again in 03/04 it said, "Well, if we were to do, if we were to re-look at those, we'd need to re-look at the asset beta too." They saw, if you include the risk on one side of the equation then you have less risk on the other. Well, that might not be quite right, but the risks are related. You either deal with them in depreciation or –

TIPPING J:

Well, if you've dealt with them more in depreciation, you don't have to deal with them as much in the beta.

MS SCHOLTENS QC:

Yes, that's right, and that's what they thought, they –

TIPPING J:

That's what they thought they were doing.

MS SCHOLTENS QC:

Yes, in the early days.

TIPPING J:

But that would be a ground for increasing the beta, wouldn't it?

MS SCHOLTENS QC:

Not if you reduce – what they've done is taken away the risk that Telecom's talking about, which is introducing new technology into the model and re-optimising their existing assets, changing their economic life effectively.

TIPPING J:

All right, well, I'm probably confused, I think.

BLANCHARD J:

And you think that Professor Guthrie's evidence is not going to be helpful to us on this?

MS SCHOLTENS QC:

Can I have a moment? I'll just check that.

ELIAS CJ:

Was it admitted? I'm getting a little confused about –

MS SCHOLTENS QC:

I'm sorry, I wasn't thinking of his affidavit evidence, I was thinking of his –

BLANCHARD J:

Yes, I meant the – what he said to the Commission.

MS SCHOLTENS QC:

Yes, yes.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

The Commission refers to it in its determination at page 551, volume 2, and notes that, at 258, it refers to, "Professor Bowman and Professor Guthrie are both experts. Professor Guthrie suggests that the impact of new technology such as wireless, and systematic capital risks, is uncertain, and could lead to a higher or lower asset beta. So the answer to your question is probably, no, Sir, it may not be helpful, but it does presumably demonstrate what much of the analysis demonstrates, and that is that it's very difficult, very impressionistic, and you're looking for comparators that aren't easy to find in this context, efficient companies providing uncommercial services in this area, telecommunications area.

TIPPING J:

It's really only Professor Bowman who expresses an opinion in it, and that's cited in the indented 39 that follows.

MS SCHOLTENS QC:

Yes.

BLANCHARD J:

There does still – and I may not be understanding this – there does still seem to be an element of reduction to compensate for something that wasn't there in the first place, because they hadn't thought that the risk, the regulatory risk affecting beta, was anything more than minimal.

MS SCHOLTENS QC:

Mmm.

BLANCHARD J:

If they then changed their mind on that, surely the first step is to put beta up and then, if you remove the new technologies, you change the regulatory risk downwards, so down it comes again. But does that justify coming down past 0.4 to 0.2?

MS SCHOLTENS QC:

They did discuss that, because that was Telecom's argument and, I mean, essentially, as I –

BLANCHARD J:

Where do they address that?

MS SCHOLTENS QC:

Now, I'm not sure I can find that. Again, it's not a short answer, Sir, but in – when they go through all of the determinations beginning on page 546, they respond to each of Telecom's submissions –

TIPPING J:

Is it at 541, starting at about 216?

MS SCHOLTENS QC:

That's how they came to the 0.4.

TIPPING J:

Yes.

MS SCHOLTENS QC:

And then how they –

TIPPING J:

Well, no, they came to the 0.2, or am I – I think 218 –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– explains how they came from 0.4 to 0.2, and then they come on to – I'm just looking at the heading, I haven't recently read this.

MS SCHOLTENS QC:

Yes.

TIPPING J:

Perhaps "recently" is a misleading statement.

ELIAS CJ:

Well –

TIPPING J:

And then they come on to Telecom's submissions. I don't know whether this is what you're referring to?

MS SCHOLTENS QC:

Well, they do that, but then, well, they go – in order to respond to Telecom's submissions, they go right through each year's determination and how the matters have developed, and that starts on 546. I mean, essentially, while there was an assumption that the tilted depreciation methodology would capture these risks, there was no evidence that it didn't. It was only when the Commission started to model, tried to model the mobile technology beyond the scorched nodes that the issue really started to bite. Prior to that we were dealing largely with just MAR and wired technology, with one year the introduction of WLL, Wireless Local Loop had a bite on the cost, but otherwise we were dealing with the technologies that they had built into their depreciation tilts.

TIPPING J:

Somewhere in the material we've been referred to, there was a reference to putting the figure up from 0.4?

MS SCHOLTENS QC:

Yes.

TIPPING J:

I remember it.

MS SCHOLTENS QC:

Yes.

TIPPING J:

And that really is my brother Blanchard's point –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– surely in order to do the thing properly, you've got to put it up and then bring it down from that upper figure, but somewhere in here there's reference –

MS SCHOLTENS QC:

To that.

TIPPING J:

– to that.

MS SCHOLTENS QC:

That was back in 01/02 when Telecom were asking for an increment on top of the weighted average cost of capital to allow for industry effect.

McGRATH J:

And that's when they got the 0.1 was it?

MS SCHOLTENS QC:

In the end they got nothing in terms of something added onto the WACC, but they got 0.1 added on to the beta.

McGRATH J:

Yes, okay.

MS SCHOLTENS QC:

So it went up from 0.3 to 0.4.

ELIAS CJ:

This maybe totally off the point because we are talking about regulatory risk here, are we not?

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

But surely the background is of increasing awareness that new technology was a greater risk than had first been appreciated?

MS SCHOLTENS QC:

Well, really, it's more that the way the Commission was modelling it was perhaps a greater risk than had been appreciated. When the Commission started to go beyond scorched node, that was brought into focus the fact that well, this is a regulatory change that wasn't anticipated.

TIPPING J:

Shouldn't that logically put the beta up?

MS SCHOLTENS QC:

Well, but the Commission simply decided not to do it. They had a number of ways to accommodate it, they could have put the beta up and continued with this, well they could have done a number of things, but maybe putting the beta up was one of them, and continue with this form of optimisation.

TIPPING J:

Are you really saying, Ms Scholtens, with no disrespect, that the Commission adopted a kind of stir the pot method, which in the end accommodates everything to the Commission's best judgement?

MS SCHOLTENS QC:

I would accept that, Sir, and I think they did their very best to be –

TIPPING J:

And I don't want to be misunderstood –

MS SCHOLTENS QC:

– transparent and –

TIPPING J:

– in using that expression.

MS SCHOLTENS QC:

Yes, yes, but in the end there were unders and overs, there were tradeoffs –

TIPPING J:

Yes.

MS SCHOLTENS QC:

– nothing's, I mean, when you focus in on one limited aspect of the model, you risk not taking into account what's going on somewhere else, and they did have a stand back overall approach to efficient, to meet the net cost test.

ELIAS CJ:

If, and maybe I'm wrong in this impression, but if one gets a sense of the Commission saying, not now, but at some point we will have to revisit the scorched node model, surely the risk of new technology is, and an adjustment that the Commission might make in the future, becomes elevated?

MS SCHOLTENS QC:

You might say that, yes Ma'am. There's also the risk, as we see, there's a Bill before Parliament that will do away with this whole modelling and –

BLANCHARD J:

Thank God for that.

MS SCHOLTENS QC:

– and so there'll be, you know, they won't get there –

BLANCHARD J:

Can we have it done retrospectively?

MS SCHOLTENS QC:

The submission is due before the select committee by Friday, so.

TIPPING J:

Well, this perhaps will be an inducement –

ELIAS CJ:

Maybe the select committee should be given volumes 1 to 11.

TIPPING J:

I think they should be given that formula that's spread right across the bottom of a page, which I can't now remember what page it was, that ought to bring them on a bit.

ELIAS CJ:

All right. I'm sorry, I have to say that you're leaving the impression that this assessment is arbitrary and you may, you may need to think about that.

MS SCHOLTENS QC:

I don't want to leave that impression.

ELIAS CJ:

No.

MS SCHOLTENS QC:

But, all the same, I have to be very clear that this is not something that can be, not something that can be assessed mathematically, and that is clear from the description of asset betas.

BLANCHARD J:

Yes, it may not be able to be assessed mathematically, but even impressions have to be logical.

MS SCHOLTENS QC:

Yes, and I submit they were and they are all supported each year by the evidence and, in particular, the 02/03 deconstruction of Telecom's PSTN beta, presumed beta, because Telecom doesn't just list its PSTN network, so it doesn't have a beta to start with, that's got to be worked out first.

ELIAS CJ:

All right, in which year are you saying?

MS SCHOLTENS QC:

02/03 Your Honour. That is where you go to see the Commission's closest analysis of what, whether 0.4 is an appropriate figure. The Commission in the submitted, the analysis is careful and thorough, as Professor Bowman recognised and it includes, it says, if you remove, if you stop optimising, the risk drops away to zero, that's if you stop optimising everything.

ELIAS CJ:

But how could the Commission stop optimising consistently with the –

MS SCHOLTENS QC:

No.

ELIAS CJ:

– the statute?

MS SCHOLTENS QC:

Well, precisely.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

That's what they said, they couldn't.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

But in terms of trying to measure the amount of risk, much of the risk was associated with optimising.

Can I make just two final points about asset betas, or the asset beta appeal, and the first is that, not, I'm just going to make one point, didn't like that one. We had a leap frog appeal here, to use a term, and this is very much an appeal from findings of fact and it's submitted that the Court should be, should take care, in terms of correcting factual errors, in particular in this area.

ELIAS CJ:

Isn't it real- isn't the criticism really one of methodology, rather than fact? I mean, it may ultimately require an assessment which is properly characterised as one of fact, but isn't the strength of the submission that's made was that the methodology wasn't logical?

MS SCHOLTENS QC:

Rational?

ELIAS CJ:

Yes, well, I'd prefer to say reasonable, but –

MS SCHOLTENS QC:

Yes, yes reasonable.

TIPPING J:

Would your submission perhaps be more cogently submitted that when there's an appeal from an expert body, courts should be particularly careful not to find an outcome unreasonable, or a step –

MS SCHOLTENS QC:

Yes.

TIPPING J:

– unreasonable?

MS SCHOLTENS QC:

Yes, yes.

ELIAS CJ:

Well, you can rely on –

MS SCHOLTENS QC:

Picking up the –

ELIAS CJ:

– Telecom's submissions in the other appeal on that.

MS SCHOLTENS QC:

Yes, yes, that's right, and this Court's judgment in *Unison.* But it is also, I mean, it is also, will be looked at as a judgment that leapfrogs and, presumably, what the approach of this Court might be in this situation. Be that as it may be. His Honour Justice McGrath's question related to the 03/04 determination –

ELIAS CJ:

That's the mimicking of tendering?

MS SCHOLTENS QC:

Yes, so it talked about, you know, whether mobile technologies, whether and how they should be introduced into the model, and the determination is found in volume 1, tab 6, and the point is made at page 116. So it's really a key part of the judgment, discussing efficient service provider. And 116, paragraph 40, refers to modelling, the outcomes of a tender process. So this is in the context of the Commission considering Vodafone's submission, that's noted on the previous page at 115, at para 35, that the Commission has not given sufficient weight to technologies that supply the service more cheaply. And at 36 it notes that it hasn't modelled the maximum level of efficiency, it's taken a scorched node approach, it thinks that's appropriate. And then at 38 it talks about how optimising to reflect the incremental costs of mobile are not aligned with its fundamental scorched node paradigm –

TIPPING J:

Aren't they really saying here that if you took this approach you'd really be moving from scorched node to scorched earth, and this reference to tender process is effectively signalling a blank sheet of paper sort of approach, rather than a, "We've got to live with most of what we've got"?

MS SCHOLTENS QC:

Well, yes, and I think they're also saying that it's not, doesn't fit with the efficient service provider standard and perhaps –

TIPPING J:

Because efficiency has got to pay respect to prudent investment decisions earlier made.

MS SCHOLTENS QC:

Yes, yes, precisely, and I have to obviously take care trying to amplify a Commission's determination –

TIPPING J:

That's what I understood them to mean.

MS SCHOLTENS QC:

Yes, yes.

TIPPING J:

Now, if you agree –

MS SCHOLTENS QC:

I do agree, and I think Justice Arnold has it right when he refers to this, that's at tab 3, His Honour Justice Arnold, at page 54, paragraph 129. So he talks about the submission from Vodafone in 128 about Vodafone arguing the TSP should select least, "An efficient service provider would select the least costly means of providing the service to its customers, including purchasing wholesale services." And then His Honour notes that it's undoubtedly correct that in competitive markets firms face make or buy decisions, and the rational choice will often be to buy rather than to make, "But in my view the Commission was entitled to reject the attempt to emulate such approach in the present context. Modelling the outcome of a tender process would not be straightforward and might unduly divert the Commission from its overall task." And here, I guess, is this, is the core, "If there were more than one mobile operator, as in this situation, for example, the Commission would have to assess their relative efficiencies in provision of mobile services."

So that would be, obviously, quite a task in itself. And then he refers to, "The Minister noted the possibility of tendering services but the Government has not yet moved to do so. The option remains but there seems to be no reason why the Commission should attempt to model such a process in the absence of clearly considered direction that it do so."

So the Commission took the view that it wouldn't be consistent with the way it was dealing with efficiencies, and that it would be very difficult, and His Honour Justice Arnold found they were entitled to take that view and I submit, to the extent I'm allowed to make submissions, that that appears to be correct.

GAULT J:

Is there anything to, in your materials, to give an indication of the extent of the impact of the mobile technology in the material years, bearing in mind we're talking about non-commercial services –

MS SCHOLTENS QC:

Yes.

GAULT J:

– which one would have thought –

MS SCHOLTENS QC:

Yes.

GAULT J:

– intuitively –

MS SCHOLTENS QC:

Yes.

GAULT J:

– is not so much where the mobile revolution was developing –

MS SCHOLTENS QC:

Yes.

GAULT J:

– and so to what extent was mobile a factor in the provision of services at the relevant time?

MS SCHOLTENS QC:

The extent to which mobile could provide these services, or did provide these services, was the subject of intensive study, and essentially I think Gibson Quai, who

– you'll find this information in three different places in the final determination, that's 03/04, in three appendices which discuss the information – Gibson Quai was the expert body that did the sampling of particular exchange service areas in the South Island around Ashburton, in the North Island around Hastings and that is in appendix 13. I think we could get quite bogged down if we tried to –

GAULT J:

I don't want you to do that. I just think you might –

MS SCHOLTENS QC:

No, I just tell you it's there, Sir, thank you. And you can also find discussion of NSL's wireless cap proposal, and that was for Vodafone I think, in appendix 9, and then the treatment of the other radio caps in appendix 2 and 3, appendices 3 and 3, sorry, 2 is the mobile technology radio cap discussed. And certainly, the extent to which mobile coverage could deal with outlying customers was a significant part of the inquiry.

GAULT J:

The outcome of which you can't tell me?

MS SCHOLTENS QC:

The outcome of which, I'm sorry, I'm being impressionistic here, but very limited coverage from existing technology, existing mobile technology, what was there to the extent required by the TSO deed.

GAULT J:

Yes.

MS SCHOLTENS QC:

So to provide that level of service, which was reasonably significant – well, what you'd expect from a line – and then to model it, very expensive.

GAULT J:

But I thought – it's just in the back of my mind that I'd seen some reference to a percentage of the service provided –

MS SCHOLTENS QC:

Yes, Vodafone said 75%.

GAULT J:

– and it seemed to be very low insofar as it was provided to the non-commercial customers.

MS SCHOLTENS QC:

Yes, they said 75% and I think Gibson Quai took that down to something very low.

GAULT J:

Yes.

MS SCHOLTENS QC:

I can't recall what it was.

GAULT J:

All right, thank you, I can look at that.

MS SCHOLTENS QC:

In terms of what, whether the service that was required under the obligation, quite different from coverage, whether it might reach you up in –

GAULT J:

Yes.

MS SCHOLTENS QC:

– coastal Taranaki or actually enable you to get the –

ELIAS CJ:

I had thought though that – yes, the outlying regions, it really wasn't suitable for, and that MAR –

MS SCHOLTENS QC:

Yes.

ELIAS CJ:

– or whatever was more likely to be continued, but the non-commercial customer base in other areas, plains, I think it was said, for example, wasn't there evidence that Telecom was actually using some of its mobile technology to reach some of those people, or am I wrong in that impression?

MS SCHOLTENS QC:

Not sure that it was, that there's evidence of that.

ELIAS CJ:

I see.

MS SCHOLTENS QC:

There might be evidence that it could, because I know 405 that's –

ELIAS CJ:

I see, yes.

MS SCHOLTENS QC:

– what they were looking at, whether CDMA –

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

– could, they had a within coverage assessment and then an outside coverage assessment.

ELIAS CJ:

Yes.

MS SCHOLTENS QC:

And that's best found in summary I guess, in the, that paper that went to the conference on the 11th of February, prior to them considering whether to extend mobile beyond the scorched node.

ELIAS CJ:

Yes, thank you.

MS SCHOLTENS QC:

And I have one, hopefully useful, reference for Your Honour about the extent to which mobile technology could be used in 03/04, at page 1, tab 6, para 42, to replace my impressionistic answer, no 140, 142 it must be, yes, 142, page 142.

GAULT J:

Which volume was that in?

MS SCHOLTENS QC:

I'm sorry, volume 1, tab 6.

GAULT J:

Thank you.

MS SCHOLTENS QC:

Page 142.

ELIAS CJ:

Paragraph?

MS SCHOLTENS QC:

If you just give me a minute, Ma'am. 218, thank you, yes, paragraph 218, "A subset of 79 ESAs have been identified as being suitable for both mobile technology and wireless local loop technology." I think there are 783, in total, ESAs. So this was the, this was the year that they applied that mobile technology cap, but it didn't bite because it was never a cheaper form of technology.

Then, finally, Your Honours, can I just make a point on the question of law submission, this is an appeal on the question of law, and Your Honours are well familiar with the argument and the approach taken in *Unison*. It's perhaps worth comparing this scheme of this Act to, for example, Part 4 of the Commerce Act, where now we have, as you will know, appeals to the High Court sitting with two experts, merits appeals on input methodologies, which is what we're dealing with here. So, what goes into the weighted average cost of capital, the courts in, the High Court in those appeals, and there are 12, will be able to assess whether the asset

betas applied, that the Commissioner's would-be approaches to asset beta, the Commissioner proposes to apply in relation to weighted average cost of capital, materially are as good as anything else or whether some other form of doing it is materially better, I think is the test under that Act, and then there's appeals only on questions of law beyond that. So there obviously has to be a contrast between what Parliament intended in legislation like this when it gives the Commission, an expert body, the ability, or the responsibility, to make difficult judgments, and the net cost test is rife with difficult judgments. That's all I have to say on these appeals, Your Honours, unless I can assist on any other matter.

ELIAS CJ:

No, thank you, Ms Scholtens. Are we going to do it in this order, or was Mr Hodder going – were you going to respond, Mr Hodder, were you intending to do that to Ms Scholtens at all?

MR HODDER:

Yes Ma'am, I think I will have to respond to what Mr Gray's about to say with my right of reply, so I will reply to both of them at the end, if that's agreeable with the Court?

ELIAS CJ:

Yes, of course, thank you.

MR GRAY QC:

Your Honour, what I understood you were hearing from me on now is Vodafone's response to the appeal in respect of the 2004/2005 and 2005/2006 determinations.

ELIAS CJ:

Are you then going to have a further reply? I'm getting a little confused about the number of appeals.

MR GRAY QC:

No, our discussion among ourselves was that this would be the last time that I'm on my feet.

ELIAS CJ:

I see, yes, thank you Mr Gray.

MR GRAY QC:

That I would deal with Justice Winkelmann's judgment.

ELIAS CJ:

Yes.

MR GRAY QC:

To the extent that I need to reply to my learned friend Mr Hodder in respect of the judgement of the Court of Appeal, and I have one point, although it will take a little while to develop on, that I will say it now, and to the extent that Vodafone wishes to participate in the asset beta issue, and it doesn't particularly, the burden of that has fallen on my learned friend Ms Scholtens, and I will do that now as well.

ELIAS CJ:

All right, thank you.

MR GRAY QC:

So if Your Honours please, these submissions are addressed to the decision of Justice Winkelmann and her findings in respect of the determinations for the 2004/05 and 2005/06 years. My learned friend Mr Hodder described the differences between the determinations for the prior year, 2003/04, and the years considered by Justice Winkelmann, as a little tweaking of the model. Vodafone says that Justice Winkelmann was correct to see that the issues before her were different, and that the inconsistencies between what the Commission did and the legislation were more stark and more significant. And they may be captured by an exchange between Her Honour the Chief Justice and my learned friend Ms Scholtens just now. In respect of asset beta my learned friend Ms Scholtens said, "Well Professor Bowen said if you stop optimising the risk is zero" and the learned Chief Justice asked, "Well how can you stop optimising consistent with the statute", and in the years considered by Justice Winkelmann the Commission stopped entirely exogenous optimisation of the access network. And the consequences of all of its prior errors came to a head in 2004/05, 2005/06, where having said from the beginning that new technologies would be included in the model as they became available, having said from the beginning that scorched node meant that the access network would be remodelled each year with new technologies as they became available, the Commission said, "We're not going to do that anymore".

TIPPING J:

Were they not entitled to change their stance?

MR GRAY QC:

After a proper consideration they may have been. What we will see is that the process from 2003/04 to 2004/05 began with a conference by the Commission in which it said to –

TIPPING J:

Sorry, pause would you, are you saying that this is really a process issue rather than a matter of –

MR GRAY QC:

I understand the difference, Your Honour, and no I'm not. What I'm saying is –

ELIAS CJ:

Well surely you're saying that the model had to be reassessed if they were going to do that?

MR GRAY QC:

As Your Honours will well know, when errors are made, often a flawed process has lead to the error. We say the process was flawed and what came to be was an error, which is a decision which is just wholly inconsistent with the statute.

TIPPING J:

You're not relying on a process point, but you're just saying that's what led –

MR GRAY QC:

Yes.

TIPPING J:

– to the inconsistency with the statute.

MR GRAY QC:

The process point was argued before Justice Winkelmann, she rejected it, and there has been no appeal against that finding, but there was a flip-flop. The Commission held a conference to decide not whether to model mobile technologies, but how to. That conference was not intended by reference to its agenda, which we'll come to

look at, to consider what might be the consequences for the asset beta or for the tilted annuity of modelling mobile technologies, Dr Hird for Telecom persuaded the Commission at the conference, and by papers produced later, that those topics did arise and the Commission accepted them and said, "We're simply not going to model new technologies any longer in the access network". And we say that is the time at which the errors which were embedded in the determinations, becoming more serious as new technologies became available, finally came into relief. And the Commission said, "We have only a limited number of choices, all of them are difficult, and we're simply going to make one of them". And we say, that's at that point that the clear inconsistency with the statute can be seen. And you can see the Commission trying ameliorate the consequences of its decision by what it does with the asset beta.

So the structure of the submissions is to look at this question as to whether or not there's a legal issue. Second, to set the platform for looking at Justice Winkelmann's judgment by looking at the parts of the decision-making processes in prior years which are not challenged, what it is that the Commission had said in the prior years, what it plans to model and then where it came to, and then we will look at Justice Winkelmann's judgment, which we say is not, as my learned friends would have it, misconceived, but is in fact an appropriate, in our respectful submission, response to the determinations.

Now both my learned friends have spent some time over the last several days telling you how complex and difficult this all is and how, because it's complex and difficult, you ought not enter into the territory but leave it to others to do so and in particular to the Commerce Commission. And I do accept that on appeals on questions of law in this area, the question of whether or not to intervene always is in play. And that question can be called a number of things. We do rely on what we understand are orthodox propositions of law. First, that the Courts are the guardians of the law by reference to *Bulk Gas Users Group*. Second, that the Commerce Commission must apply the statute, and application of a model or formula is not a substitute for an application of the statute, that's *Unison*, and third that we do need to look at these words and understand the extent to which they are legal. We start by saying that the interests are those of the users. For Vodafone, the levy is a tax. It's an amount required by the community that it pay to its competitor to fund a social service, and Vodafone essentially is a funding mechanism by which the tax is spread among those who consume the service. And my learned friend has then said, by reference

to *South Yorkshire*, "Where a word is capable of a range of legitimate meanings and the approach taken by an expert body is to select from within that range, the Court should not interfere." And *Cozens v Brutus* was seen as the application of a similar principle, perhaps not in an expert capacity.

But we ask the Court to stop and think about what actually was involved in cases like *Cozens v Brutus* and *South Yorkshire.* *Cozens v Brutus* involved the word "insulting". And what Lord Reid said was, "That is not a word the requires refined legal determination. The decision-maker knew what "insulting" meant. The question is whether the conduct at issue was. And it does not help to try and re-litigate the judgment about the conduct by refined argument about "insulting". And similarly in *South Yorkshire*, the word at issue is "substantial" where it's used in a competition statute. The same word is used in our competition statute in a very similar way. Both in the United Kingdom and here, the word "substantial" had already been construed by courts and the legal meaning of the word within the context of the competition statute, had been declared. The issue in *South Yorkshire* was how big, how substantial was substantial enough. And what the House of Lords said is, "Well it does not help to convert that factual question into a legal one by seeking to further refine the construction that the Courts already have placed on the word."

Now we say that's a far cry from looking at a phrase like "unavoidable net incremental cost to an efficient service provider," and that whereas one can well understand Lord Reade saying that decision-makers know what "insulting" means – it's a word in common usage, it has a common meaning, we don't need to stand around together as practitioners and Judges to debate it to see if something can sensibly be said – very much can be said about unavoidable net incremental costs to an efficient service provider. And because of the complexity of that phrase, the balance to be achieved by the concepts held within it and the tension between them, the courts are the best body.

TIPPING J:

Doesn't that proposition, that the balance to be achieved between the various components of the phrase, and then you went on and said something else helpful, Mr Gray, doesn't that really underline that the striking of the balance is a matter of assessment and judgment, not necessarily a question of law?

MR GRAY QC:

In all the cases of this type, Your Honour, there are two issues. The first is what do the words mean and the second is how do we apply that –

TIPPING J:

Yes.

MR GRAY QC:

– meaning to the facts of the case.

TIPPING J:

Interpretation and application.

MR GRAY QC:

Vodafone says this is an interpretation issue.

TIPPING J:

So they got the meaning wrong. It's not that they applied the right meaning in an erroneous manner?

MR GRAY QC:

Correct, Your Honour. But in any event, Your Honours, we make the more general submission that the question whether or not to interfere, whether or not to intrude, is a nuanced one assessed by reference to the statute, the questions under consideration and the type of error alleged. And in this case, in respect of 2003/04, Justice William Young, President of the Court of Appeal, would intervene. Justices Arnold and Glazebrook would not, at least for the time being, and Justice McGechan would not. And he expressed in different ways Their Honours have come to different position in respect of 2004/05 and 05/06, Justice Winkelmann would have because, in Her Honour's view, of the decision by the Commission no longer to model at all.

TIPPING J:

Is the point of interpretation what, if anything, does the word "unavoidable" add to the rest of the composite phrase?

MR GRAY QC:

Yes. And can I let Your Honour into the way we'll re-visit that topic, again to explain our position in the hope that it becomes clear.

TIPPING J:

No, you do it in your own good time, Mr Gray –

MR GRAY QC:

Yes I do.

TIPPING J:

– but I just wanted to have that understanding before you proceed.

MR GRAY QC:

The answer is yes, Your Honour.

TIPPING J:

The answer is yes?

MR GRAY QC:

Yes.

TIPPING J:

Yes, thank you.

ELIAS CJ:

Sorry, you were just starting to say that Justice Winkelmann –

MR GRAY QC:

Would interfere.

ELIAS CJ:

Yes.

MR GRAY QC:

And she would do so because the decision made by the Commission no longer even to model new technologies as they become available was inconsistent with the

statute, cannot be supported by reference to the task the statute imposes on the Commissioner. But expressed in different ways, each of Their Honours who have looked at this most complex problem have reached their own differing positions on whether or not this is a case in which it's appropriate for the Court to intrude, and that is the policy question that underlies what the Court is being asked to do. I acknowledge it is a live one. I acknowledge that on the path these three pieces of litigation have followed on their way to this Court, the balance is 3:2 against me, but I say that's including Justice McGechan declining to become involved because he said the issue was not a legal one. I say this is an appropriate case for the Court to interpret the statute and to consider whether the determinations are consistent with what the statute means and requires of the Commerce Commission.

TIPPING J:

I don't quite understand this point. If there has been an error of law, we're almost duty bound to interfere, intervene, aren't we? If there hasn't, we don't.

MR GRAY QC:

We say –

TIPPING J:

Where is this slippery slope?

MR GRAY QC:

My learned friends are saying it's not a question of law, merely a question of fact for the Commissioner.

TIPPING J:

Well, we have no discretion on that. Either it is or it isn't.

MR GRAY QC:

And we say it is. And as Your Honour rightly asked me a moment ago, does it turn to a very large extent on whether or not the word "unavoidable" has a meaning and if so, what that meaning is. Because as is very clear from the judgment of Justice Arnold in 03/04, and from the Commission's own workings, the position they have reached depends on the word "unavoidable" not having a meaning but being there as surplusage.

McGRATH J:

Does it really come down to the Court having to consider the extent to which the Act sets boundaries on what the judgment of the Commission is to be?

MR GRAY QC:

Yes.

McGRATH J:

The Commission operates within those boundaries and its judgment is final, a bit like the opinion of the Secretary in *Bulk Gas Users*. But stepping outside of those boundaries, there is no authority for the Commission to go, and it's an error of law.

MR GRAY QC:

As I listened to my learned friend Mr Hodder develop his argument by reference to *South Yorkshire*, I became reminded of the old notion of error of law within jurisdiction and the argument –

TIPPING J:

Don't want to go there.

ELIAS CJ:

I thought you were.

TIPPING J:

Yes, almost.

MR GRAY QC:

That's precisely the point I'm making, we don't wish to go there because we say we've learnt that that's a fallacious way, an unhelpful way of looking at this very question. We say –

TIPPING J:

With great respect, isn't the question – it can be formulated by the concept of boundaries, but is it no, did the Commission misdirect itself in law in coming to the view that "unavoidable" added nothing?

MR GRAY QC:

With respect, Your Honour, yes. We say that's what the Commission did. We say that in respect of the determinations presently being addressed, 2004/05 and 2005/06, the Commission could not, consistently with the statute, conclude that new technologies would no longer be modelled within the Access network and the process by which the Commission came to do that was to conclude that the word "incremental" had no meaning.

TIPPING J:

Unavoidable.

MR GRAY QC:

Unavoidable, I'm sorry, had no meaning. And that is a misdirection.

TIPPING J:

And you start on your side of the proposition that normally each word in a composite phrase is designed to do some work?

MR GRAY QC:

Yes. And we say unavoidable does different work within the definition of net cost.

TIPPING J:

Really, and you're going to go on to this?

MR GRAY QC:

Yes.

TIPPING J:

To say what work?

MR GRAY QC:

Well, my job's to try and make this simple, not complex.

TIPPING J:

No, no, but to say it does some work, you've go to say what work, haven't you?

MR GRAY QC:

Yes. And we say –

TIPPING J:

You can't just say in theory it does some work.

MR GRAY QC:

Your Honour we say "efficient service provider" is a phrase which controls the network. It's the part of the definition that addresses the decisions made by the provider in the construction of the network. We say "unavoidable" controls the costs to the network of providing the service. And so we say that the definition holds in tension an evaluation of whether the network developed by the provider to provide the service is an efficient one or not, or whether it ought to be optimised so as to cap the amount that can be recovered by the employment of the network. But "unavoidable" controls the choices the provider makes in the provision of the service, and requires that it make choices that reduce costs, essentially. Do it at the cheapest way, where you have three ways, take the cheapest one.

TIPPING J:

Provided that delivers sufficient quantity and quality.

MR GRAY QC:

Oh yes.

GAULT J:

Cheapest today or cheapest in the long run?

MR GRAY QC:

Cheapest in the long run is answered by "efficient service provider", it's by the development of the network. "Unavoidable" addresses a different question. It is from within the network as optimised by application of the word "efficient", with an efficient service provider, how do you avoid cost?

ELIAS CJ:

I don't see how they can be split in that way if cheapest is required only over the long run, which I suppose is arrived at in application of section 18. I don't see how that doesn't apply to the choices made by the provider.

MR GRAY QC:

"Efficient" needs to be achieved in the long run.

BLANCHARD J:

Dynamically efficient?

MR GRAY QC:

Yes, and we've come to look at section 18 only from the position of Telecom, not from the position of competitors and others, but even taking just the position of Telecom for a moment, section 18 recognises that dynamic efficiency has a long view and that decisions have long-term consequences, but where there's an overlaid network, where there's a cheaper way already in place, and there's simply a choice to use an old, more expensive way and, what's more, when that old, more expensive way is only old and more expensive because it requires repayment of a hypothetical investment not made, in our submission a degree of unreality comes to settle on the determination. My learned friend Ms Scholtens used the analogy of a fridge and she talked about an old fridge half full and a decision about how to keep chilled one additional can of beer, and she said, "We don't need to build a new fridge, you just put the can of beer into it". What these determinations do is revalue the old fridge as if its new and require the person having their beer kept chilled to pay back a part of the new value of the old fridge. That's the decision. And we say that comes from an inappropriately rigid adherence to NPV=O, which is not required, not necessary to give effect to the statute, and is inconsistent with the word "unavoidable" where it appears in the definition of net cost. It is unchallenged that Telecom made no new investments and in this Telecom is not like every other TSP, it's not like every other ESP, it is different, that's why it's got its own section within the Act, section 71, it's employing existing assets, it's providing not a new service but an established service, using established infrastructure. And it's also unchallenged that from the outset –

TIPPING J:

Why, then, did the legislation not simply say "Give Telecom a fair return, in its actual situation". Why did it focus on this hypothetical efficient provider? Because if you were just going to say, "Well, it's all about Telecom" surely it would be very simple to say that in the legislation, and just say, "Well, give it – allow them whatever seems a fair return" and your people, and everybody else has to contribute?

MR GRAY QC:

Partly, Sir, there was a desire to adopt one formula for Telecom's existing service and any potential new ones, partly the statute does that by the use of the word "incremental". How much extra, we would say in respect of most services that word would be answered by new, how much new investment is made.

TIPPING J:

But would that not mean on your thesis you'd simply say, "Well let's look and see how much extra Telecom in the real world is having to meet for this uncommercial". What I can't, it'll be me, Mr Gray, I can't grasp why you're trying to shift the focus onto the actuality of Telecom, when the legislation seems to be directed towards a hypothesis?

MR GRAY QC:

I would like to defer if I may, Sir, dealing with the interplay between the real and the hypothetical, it is an –

TIPPING J:

All right, defer it then.

MR GRAY QC:

– important question and I do have submissions to make, if I may on that.

TIPPING J:

Of course.

BLANCHARD J:

But "incremental" clearly doesn't mean new, it means additional –

MR GRAY QC:

Well, it may not mean only new.

BLANCHARD J:

– or extra.

MR GRAY QC:

It means additional.

ELIAS CJ:

That's your point, that for an existing provider it means, it doesn't mean new, but for a new provider, an entrant, it would perhaps mean new?

MR GRAY QC:

For a new entrant it would always –

ELIAS CJ:

Yes.

MR GRAY QC:

– mean new. For an existing provider it may.

ELIAS CJ:

It may, yes.

MR GRAY QC:

But it may not.

ELIAS CJ:

But it may not, yes.

BLANCHARD J:

Well, for an existing provider it will mean both, unless everything's completely static?

MR GRAY QC:

Yes. I did want to just demonstrate to Your Honours where it is found within the record that the Commission had consistently expected to include new technologies in its models, as they became available. There's an awful lot of work building up to –

BLANCHARD J:

Is that in dispute, that particular point, that it originally thought it would include new technologies, without necessarily –

MR GRAY QC:

Yes.

BLANCHARD J:

– seeing what they would be?

MR GRAY QC:

I don't understand it to be, but the Commission did come to refine its position in 2004/05 and 05/06, when it said well –

BLANCHARD J:

This is a lot harder than we thought it was going to be?

MR GRAY QC:

Yes. We accept that application of the NPV=0 formula to our decision to model and introduce new technologies produces consequences and for that reason, we think it is more important that we stay with NPV=0 and return to Telecom the hypothetical cost of the investment and the infrastructure that's employed, than that we continue to model new technologies.

Perhaps it's enough if I just read into the transcript that in respect of the 2001/02 determination, which is found in the case at volume 4, under tab 48 on page 1687, and paragraph 457.

ELIAS CJ:

Sorry, paragraph 1?

MR GRAY QC:

457, page 1687. The Commission –

BLANCHARD J:

I'm sorry, Mr Gray, could you give me that again?

MR GRAY QC:

Of course, Your Honour. It's in the case at volume 4, under tab 48, at page 1687, and paragraph 457. That's the passage that Your Honour the Chief Justice recalled as being the conclusion that at that time copper wire remained the most efficient and best in-use platform for TSO delivery. A record in 458 of submissions that wireless technologies would be cost-effective. 459, the decision to implement a wireless technology price cap. At 460, the Commission notes, "The emergence of innovative alternative wireless technologies for the provision of telephony access, including the CDMA wireless local loop. It is expected that the costs and capabilities of alternative

access technologies will be sufficiently mature to be considered proven in use for modelling high-cost areas in subsequent TSO determination periods." In other words, once we're satisfied that the quality of service will be sufficient and CDMA is a mobile technology, then it will be modelled in future periods.

And I wonder, Justice Gault, if I can just deal with one question. The proposition is not that what will then be provided is mobile service, but that the equipment employed in providing mobile service will be used to provide the point-to-point services which replicate the fixed service available from a copper wire, and there are ways of ensuring that what is a service to deliver a telephone call to a place doesn't slip to becoming a mobile service. It's merely the use of the equipment and infrastructure to provide the equivalent service that's involved.

And perhaps the correct point for considering 04/05 is to see what the Commission had said in 03/04 on the topic, and that's found in the determination for those years in volume 1 of the case at tab 6, page 126, starting at paragraph 100. NIRA, who are an economic consultancy advising Telecom, submitted on the draft, that the draft determination "places significant weight on generated annuities that have a net present value equal to the initial costs of the asset associated with the most efficient technology." So here is Telecom asserting, as it always did consistently, NPV=0 is important, and we must get back the cost of our copper wire. According to NERA, this can be achieved either by committing to a particular technology mix, that is determining the parameters for the tilted annuity formula, and remaining on the same profile, or by using an adjusted tilted annuity formula. NERA notes the simplest way of achieving this would be to select today's least-cost technology and to apply the tilted annuity to that technology in perpetuity.

So Telecom's saying the prior year, don't introduce new technologies. Pick our copper wire today and use it in perpetuity and pay back to us the assumed value of the copper wire over its life. And how much is the life? Well, the Commission goes on to address that at paragraph 101. "The Commission considers that such an approach places a very limited interpretation on the statutory requirement to estimate the net cost of the TSO for an efficient service provider. The Commission would be required to assess an efficient service provider at "T" – that will be time – "=1". After that point, no further optimisation would be undertaken for a considerable period of time, or any such optimisation would be offset. For example, the asset life used for underground copper wires in the access network is 20 years." So the Commission

says, well if we were to decide not to introduce new technologies, that would be inconsistent with the Act and, what's more, the consequences would last for a very considerable period.

Now, Your Honour, yesterday we took a break at 10.30, I don't know if you wanted to do so today.

ELIAS CJ:

Yes I do, did intend to do so, so thank you for reminding me. We'll take a 15-minute adjournment now.

COURT ADJOURNS: 10.33 AM
COURT RESUMES: 10.52 AM

MR GRAY QC:

Thank you, Your Honour. We had just finished looking at paragraph 101 of the determination for 2003/04. At paragraph 102 and following, the consequences for the asset beta that the Commission identify as a result of the NERA proposal and its consideration, I don't take Your Honours to those, but those are the other side of this issue, and they do demonstrate the extent to which the Commission is thinking in relation to the asset beta, is linked to its thinking in relation to optimisation of what it comes to call "exogenous assets" within the access network.

The conclusion is found at 113 and following, "Under the NERA approach, an efficient, optimised network could be built during the first TSO round (as was done in 2001/2002 determination), and the Commission would commit to retaining that network configuration for the duration of the assumed asset life. Under such an approach, the TSP is assumed to be statically efficient in year 1 (when the original investment is made) –"

ELIAS CJ:

Sorry, where are you reading from?

MR GRAY QC:

114, Your Honour.

ELIAS CJ:

Thank you.

MR GRAY QC:

"– but ignores any new technology that emerges over time. This results in the guaranteed recovery of that initial investment. The Commission does not consider this is consistent with the statutory requirement to asses the net cost of an efficient service provider on an annual basis." But, of course, that's what the Commission comes to do the next year. "If the return of capital to the TSP was determined on an ex-post basis, as proposed by NERA, the capital risk faced by the TSP would be largely eliminated. In other words, the appropriate asset beta for the TSP would be close to zero, with the resulting WACC converging to the risk-free interest rate (reflecting the elimination of risk from the provision of the TSO). Having reviewed the NERA submission in relation to the return of capital to the TSP, the Commission does not consider that the approach proposed by NERA is appropriate for the purposes of determining the net cost of the TSO, as it effectively guarantees the TSP's initial investment and thus is likely to undermine the incentive effect of the efficient service provider standard."

So that's where the Commission got to in its 2003/04 determination in respect of optimisation within the access network. Now remember in that year Vodafone's complaint is that it did employ mobile technology assets but it employed them in an artificial and inappropriate way. The Commission says, well, we do that because to do otherwise is to be inconsistent with our scorched node decision made at the beginning.

So I just want to talk for a moment, if I may, about scorched node. It is not a term of art. It doesn't have –

ELIAS CJ:

It's certainly a term of artifice.

MR GRAY QC:

Precisely. It doesn't have just one meaning. It means different things in different countries and it actually means whatever you want it to mean. I ask you to look in the case at volume 2, under tab 30, which is the Cornerstone issues paper. And at page 969, from paragraph 158, the Commission discussed whether to adopt scorched node or scorched earth. It concluded its discussion at paragraph 165 by

saying, “There is no precise, universally agreed definition of the scorched node approach. Regulators differ with regard to questions around whether the location of all switches is held fixed or only the major switches, and whether the technology used can be changed in all cases. Ultimately, the exact approach the Commission takes when adopting a scorched node methodology needs to be guided by an assessment of the extent that optimizing each aspect of the network will lead to costs differing by an unreasonable degree from those faced by the TSP in practice. By requesting the TSP to provide information on the actual location of nodes and numbers of customers served by each node, some of the concerns about the scorched node approach should be able to be overcome.”

What the Commission is saying is scorched node can mean different things to different people. It means what you want it to mean within your modeling, and what it really does is reflect the boundary between the parts of the network that the Commission is going to require be remodeled each year, and the parts it will treat as having been the result of historical investment which have to be recovered over time and therefore protected. And the choice about where that boundary lies is itself in part affected by technology available and where the customers are.

And in this case the choice made by the Commission is to accept the location of Telecom’s switches and the location of wires to the last switch, but to optimise them by requiring them to meet modern standards each year. There is nothing bright-line or magical about where the nodes are. And therefore when we talk about scorched node we are doing no more than talking about the place within the network from which it’s appropriate to consider the network on a greenfields basis or a scorched earth basis. The choice made by the Commission up to 2003/04 was that that place was the local switch in the wire network. Telecom argued the choice should go all the way to the customer, and the Commission concluded in 2003/04 that to do so would be inconsistent with the legislation, because it would disincentivise new investment by Telecom. There is no reason why the node cannot be regarded as the place at which calls provided by employing mobile technology are connected back to the core network, that simply becomes a new and different node. It is true that in respect of a cluster of commercially non-viable customers, electing to provide using mobile technology and deliver the calls to the core network at a different place than the local switch will cease to employ parts of what was previously regarded as the core network. It does not mean that that part of the network is stranded. That part of the network may still be employed to serve other customers, or to provide other services than TSO services. It doesn’t mean it’s treated as having

no remaining value. It simply says that the TSO service can be provided more cheaply by employing mobile technology and delivering the calls to the network at a different place.

ELIAS CJ:

But the reason a provider might not want to do that is because it can get higher value use from the mobile network, is that right?

MR GRAY QC:

But, well –

ELIAS CJ:

I mean, if it were cheaper to switch, presumably, and use the established network for other reasons, one would imagine the provider would.

MR GRAY QC:

Yes. In this case the complicating factor is that mobile technology may have higher operating costs –

ELIAS CJ:

Oh.

MR GRAY QC:

But where the costs of providing service by the wires are weighed down by the need to repay the hypothetical 2001 value of the wire –

ELIAS CJ:

Is an incentive to stick with it.

MR GRAY QC:

– the costs become much greater.

ELIAS CJ:

Yes, I see, yes.

MR GRAY QC:

And the dynamic efficiency ramifications of incentivising the provider to continue to use its copper wire, because to do so enables it to recover the 2001 hypothetical value of that wire, means that there's a disincentive to invest in new technology and a dead weight to the community.

And so between the 2003/04 determination, the hearing of Vodafone's, and the making of the 20040/5, and 05/06 determinations, Vodafone had commenced its proceedings and had the argument before Justice McGechan. And, following that, the Commission called a conference, and the agenda for the conference is found in volume 9 of the bundle –

ELIAS CJ:

We've already been to this, of course, I don't know whether it was you that took us there?

MR GRAY QC:

No, I didn't, Your Honour.

ELIAS CJ:

No. Thank you. Sorry, volume?

MR GRAY QC:

9.

ELIAS CJ:

9.

MR GRAY QC:

Tab 94. The purpose of the conference, the purpose of the letter, is for the administrative arrangements for the conference, is the background, is that draft determinations have been released, having received submissions. The Commission's prepared a paper showing an updated response to the submissions, and the paper shows the major changes that have been investigated in regard to the MT cap. This includes the use of actual Telecom CDMA, which is mobile technology, prices, and a statistically-based learning sample to calibrate the MT cap. Then there's an agenda, under the heading, "Updated MT Cap", "Discussions are expected to include: the assumptions underpinning the

Commission's refinement of the CDMA MT cap; the selection of the exchange areas to which the cap can be applied; the arithmetical/statistical accuracy to which the MT cap cost should be determined. Please bring your experts along." And then, at 3954, is the paper. The scope of the paper is "to provide a framework that the parties can respond to over planned developments to the philosophy behind the MT cap to be used in the 2004/05, 2005/06 TSO models". Radio design, the draft determinations utilise three radio caps, including mobile technology. "Radio Engineering Design", that Telecom has existing radio assets, this includes CDMA, paging and DMR sites, they can be used to provide service. "Service is available from these existing sites at an incremental LRIC" – long run incremental cost – "(see pricing below). These sites do not have to be inside the ESA boundary, but can in principle be anywhere in New Zealand and also be shared between multiple ESAs."

ELIAS CJ:

I've lost where you are in this.

MR GRAY QC:

3954, Your Honour.

ELIAS CJ:

Yes.

MR GRAY QC:

Refinement of the –

ELIAS CJ:

Oh I see, at the bottom, yes.

MR GRAY QC:

Yes. And then (b) over the page, "The MT cap may use or share existing cell sites that are available in the modelled TSO period. The design does not assume that an MT site that may be created in an adjacent area to provide greenfields service for CNVCs in the second ESA is available to provide service in the first. This approach has been adopted because it cannot be that ESAs adjacent to the ESA under examination are all CNVCs which have been serviced by greenfield radio facilities... Greenfield sites necessary to provide service for commercial non-viable customers

will have to be at the full LRIC cost of this site. This will include: power, roading, transceiver and whatever else is required to provide service." Now in the prior year Telecom –

ELIAS CJ:

What's a LRIC site? Sorry, LRIC cost?

MR GRAY QC:

Long run incremental cost, it's the –

ELIAS CJ:

Thank you.

MR GRAY QC:

In the prior year, Telecom's – Vodafone's complaint was that in modelling mobile technologies, the Commission had made a mistake by ignoring existing sites, and by using mobile technology simply to transport calls between the customer and the local switch. What this shows is that by the time of the conference the Commission had accepted that the overlaid network should be used, existing sites, whether within the cluster, or adjacent to it, could be used, but that if Telecom in order to provide service using mobile technology had to build a new site, the full cost of that site would be included in the model. Implicit in that is that the full cost of existing sites would not be included in the model because the capital involved is not incremental, they were there anyway to provide other services to other customers, or perhaps to provide mobile services to commercially non-viable customers. And Vodafone says that's what the Commission should have been doing all along, and then there's discussion of Telecom's existing assets and LRIC costs. And then Dr Hird raises his point, he clearly is successful because further draft determinations are published which do something different, and the final determinations are completely different, and they can be found, in material respects they're the same, the 2004/05 one is found in volume 2 of the case, under tab 25.

The Commission, on page 512, begins at paragraph 46. Dealing with TSO instruments under section 70 of the Act. Of course Telecom's instrument is not a section 70 TSO, it's a section 71 TSO. So the Commission starts from treating Telecom as if it was a section 70 TSO when it is not. Telecom says, well there's no difference, there's only one TSO regime and it applies to both, and we say there is a

difference because of Telecom's incumbency and its existing obligation to provide existing services, using existing resources.

BLANCHARD J:

But it is deemed to be a TSO instrument?

MR GRAY QC:

Yes it is.

BLANCHARD J:

As if it had been declared to be a TSO instrument under section 70. Isn't that part of it, saying treat it as if it was under section 70?

MR GRAY QC:

Treat it as an instrument of the kind, referred to in section 2, oh, I'm sorry.

BLANCHARD J:

As if it had been declared to be a TSO instrument under section 70.

MR GRAY QC:

Yes, do –

BLANCHARD J:

Not just deemed, but it's got to be treated, I would have thought.

TIPPING J:

Deemed for all purposes.

BLANCHARD J:

Yes, I would have thought that's pretty clear.

MR GRAY QC:

The distinction that we're drawing is not affected, in our respectful submission, by the observation Your Honour has made, because it remains the case that this is an existing obligation to continue to provide existing services using existing assets, rather than a new service provided following a process of consultation and the other things that section 70 provide for.

The significance of the point, Your Honour, is only whether, in the end, the Commission's decision that the concept NPV=0, the concept that Telecom must have returned to it the hypothetical 2001 cost of its wires, is correct and should permit the Commission, consistently with the statute, to ignore new technologies and the efficiencies that result from it. That's the context within which that question of whether or not the fact that this is a TSO under section 71, rather than section 70, matters.

GAULT J:
If this is important to you, I don't follow the point you're making.

ELIAS CJ:
Which paragraph are we at, I was copying Justice Tipping, who was on page 512, but –

MR GRAY QC:
That's where we are, Your Honour.

TIPPING J:
Oh, thank goodness. I haven't been caught.

MR GRAY QC:
Justice Gault, the point is a very small and preliminary one and it comes together in my submission that the Commission did not need to conclude that it should return to Telecom the hypothetical 2001 value of its wires and that –

GAULT J:
Now, I accept that, but isn't the issue of whether the Commerce Commission could conclude, not whether it needed to?

MR GRAY QC:
We go the step further and say it couldn't, that it's inconsistent with the legislation to do so.

TIPPING J:
And this point is the foundation for that submission, is it?

MR GRAY QC:

Yes. Well, not the foundation –

TIPPING J:

A major plank in its submission?

MR GRAY QC:

No, to be candid, not a great deal, I accept, turns on whether, on the distinction between section 70 and 71 TSOs.

BLANCHARD J:

That's good, because it would have been *tabula in naufragio*.

ELIAS CJ:

Shipwrecked.

MR GRAY QC:

That much I hid.

ELIAS CJ:

These two concepts, are they necessarily linked? You say that the Commission was wrong to work on an NPV=0 on the basis of the 2001 hypothetical cost of wires to Telecom and ignore new technology?

MR GRAY QC:

Yes.

ELIAS CJ:

Do you say that starting with the hypothetical 2001 cost of wires was itself not consistent with the statute –

MR GRAY QC:

Yes.

ELIAS CJ:

– or do you say it's inconsistent because they didn't factor in new technology, because in fact they make, in their 2001 determination as I understand it, is really based on their accepting that to the node there is no other service that's available. But you still say, do you, that they couldn't start with the 2001 hypothetical value, sorry –

MR GRAY QC:

There's a lot in that, Your Honour, can I –

ELIAS CJ:

There was probably not much, that's the problem.

BLANCHARD J:

No, I was wondering the same thing, whether the submission ran –

ELIAS CJ:

Together –

BLANCHARD J:

– that far.

ELIAS CJ:

– for two things.

BLANCHARD J:

Round that far.

MR GRAY QC:

We say it was wrong to find that Telecom's embedded costs in its existing network needed to be returned to it at 2001 hypothetical values.

ELIAS CJ:

Yes.

MR GRAY QC:

And we say the decision to do that is, as we shall come to see in a moment, what drives the decision by the Commerce Commission to exclude new technologies. It

concludes that it must exclude new technologies, because otherwise it will not return to Telecom the hypothetical value of its wires in 2001. So it's not either or or both, it's one leads to the other.

ELIAS CJ:

It's a consequential.

MR GRAY QC:

Yes, and the 2004/05 is the time at which that consequence becomes apparent.

ELIAS CJ:

Because it wasn't – ?

MR GRAY QC:

Previously.

ELIAS CJ:

Previously.

TIPPING J:

Are there two points in that? It was wrong to treat Telecom's existing network at all, the more so at hypothetical values of 2001, or just the second step?

MR GRAY QC:

No, both.

TIPPING J:

Both?

MR GRAY QC:

Mmm.

TIPPING J:

So you're saying they should have ignored what was there on the ground?

ELIAS CJ:

Revalued?

MR GRAY QC:

Yes.

TIPPING J:

Well, both at all, and certainly not revalued, there's two steps in that.

MR GRAY QC:

Yes.

ELIAS CJ:

Are you saying they should have taken the depreciated cost?

MR GRAY QC:

To the extent that it had not already been recovered by depreciation.

TIPPING J:

If it had a nil value in the books.

MR GRAY QC:

Because it had already been recovered.

TIPPING J:

Been depreciated – then it shouldn't have been taken in at all.

MR GRAY QC:

Yes.

BLANCHARD J:

So they should've adopted depreciated historical cost?

MR GRAY QC:

Yes. It's what the ACCC has come to call "depreciated actual cost" in its approach. Which it's adopted to the same question.

BLANCHARD J:

When did the ACCC come to do this, for the first time?

MR GRAY QC:

The last several years Your Honour.

ELIAS CJ:

And is that partly, does that mean also, well is – this doesn't undermine efficiency because it's forward-looking and there is no need to be concerned about the historic efficient decisions that were made, 2001 could be taken as the – as ground zero, I suppose.

MR GRAY QC:

The way in which it is said, that efficiency requires a return to Telecom –

ELIAS CJ:

Yes.

MR GRAY QC:

Of its hypothetically efficient investment in 2001, is that to do otherwise is to disincentivise a provider from investing in new technology.

ELIAS CJ:

Yes.

MR GRAY QC:

Vodafone says about that, where the investment is already recovered, the incentive structure may be different.

ELIAS CJ:

Yes I see.

MR GRAY QC:

And what is more, it's a very narrow view of efficiency. Because the relevant efficiencies, so far as section 18 is concerned, include both Telecom and its competitors. It is not only the effect on the provider that has to be considered, but the effect on those who are making the contribution, and that arises from section 18, subsection (1), and in any event we say where the relevant investment is already recovered, not only does the mix change, but to entitle the provider to recover the hypothetical new value of the recovered investment is to disincentivise investment in replacement technologies because of the risk of cannibalisation of the network. And

so we say the Commission in addressing efficiencies has focussed too narrowly on this one question of the conditions which would incentivise a provider making an investment for the first time to continue to invest. And we say it's the problem discussed in *Unison*, it's taking a formula and elevating it so that it itself becomes an answer, rather than pausing and stepping back and asking the bigger question.

GAULT J:

This seems to be a very much wider argument than I had understood was essentially your case, that the new technology should have been brought into the assessment, but now you're saying the whole assessment should be out the door, because you want to go back, in effect, and depreciate the whole of the network that was in place at the time, 01. That seems to be a very much broader argument than I understood you had been making.

MR GRAY QC:

It certainly, Sir, is a broader argument than I made in my first submissions, but my first submissions were directed to the appeal in respect of the 03/04 determination, and this is in respect of 04/05 and 05/06, when the problem changes and we say that it's a bit like a chain, that one thing leads –

GAULT J:

I don't see how this problem changes, because it's directed at the very beginning, 01.

MR GRAY QC:

It was not clear through the determinations, the extent to which the Commission had truly provided for appropriate recovery by Telecom of its hypothetical investment in wires in the annuity tilt. And Your Honours have seen that Telecom has kicked on with this topic because it felt it had not been appropriately compensated in the annuity tilt for the risk of stranding of its assets in what the Commission had done. Other parties looked at the tilt and thought, well, we can live with that tilt, but Telecom came to persuade the Commission that it hadn't in fact compensated Telecom adequately for the investment in the wire within the tilt, and that there was an uncompensated risk of asset stranding, and that came together finally in the 04/05 and 05/06 determinations, and it's because the Commission concludes that it cannot sensibly include new technologies in its model, because to do so risks failing to compensate Telecom for the investment it has made in its – in 2001 in the wires used to provide the service, and that if it did include new assets in the model it would have

to either substantially alter the tilt or alternatively provide some other mechanism for compensating Telecom, which would be a zero-sum game in the sense that what was given back with one hand would then be recovered with another, that it reached the decision that it did.

TIPPING J:

Are you saying the problem always existed but it didn't really matter until the 04/05?

MR GRAY QC:

Partly, Your Honour. It didn't matter because until 03/04 new technologies were not accepted as being capable of providing alternative services, but partly it wasn't apparent because of the uncertainty around the tilt and the asset betas.

TIPPING J:

It's a very fundament starting point, is it?

MR GRAY QC:

Yes, is it right to compensate the provider –

TIPPING J:

Give them a capital asset that doesn't exist?

MR GRAY QC:

Or is fully recovered.

TIPPING J:

Or is fully recovered, sorry, that's what I meant, yes.

MR GRAY QC:

A 20-year asset.

BLANCHARD J:

I suppose a question might be whether it really does impact adversely on dynamic efficiency, if the Commission says to Telecom, "We're not going to allow you to recover the value of your assets at 2001, to the extent they have already been

depreciated at that point, but you can continue to depreciate those assets to the extent that they haven't been depreciated, and you will get depreciation, and the other returns, capital returns, are on new assets which you introduce efficiently".

MR GRAY QC:

Yes.

BLANCHARD J:

Now, I suppose it could be said that there wouldn't be any disincentive to an efficient provider on that basis, because it would know that if it made an efficient future investment, it would get its recovery on that.

MR GRAY QC:

Precisely.

BLANCHARD J:

Is that the argument?

MR GRAY QC:

That's the argument being made, Your Honour.

TIPPING J:

And I wonder whether, Mr Gray, that has the corollary that if you look at the definition of net cost, meaning the unavoidable net incremental cost to an efficient service provider, that was intended to mean that the Act is generic, but when you actually apply it, it means to Telecom acting efficiently?

MR GRAY QC:

Yes. Your Honour Chief Justice Elias explored this point with my learned friend Mr Hodder. There's a definite article in section 84 and an indefinite article in the definition, and the question is whether the definite article means we refer to the particular provider, or whether it falls to be subsumed within the indefinite article in the definition so they need to be treated as hypothetical, and a significant volume of submissions were made about Winkelmann J referring in her judgment to actual costs, and we take that to mean no more than what Winkelmann J was doing was saying what the Commission has done is wrong because it returns, both a return on and a return of, an investment not actually made because it employed, it results from

the employment of assets which have previously been recovered, or at least to the extent that it does.

TIPPING J:

But if the definition is expressed generically, as it is looking at the definition on its own, it doesn't necessarily follow that it shouldn't be applied to the particular service provider –

MR GRAY QC:

No.

TIPPING J:

– acting efficiently?

MR GRAY QC:

That's, that, we accept that, Sir.

TIPPING J:

Yes, well I'm sure you would, but maybe I didn't fully follow the force of the exchange to which you referred a few moments ago, but this is pretty fundamental to the whole –

MR GRAY QC:

Yes.

TIPPING J:

– set up isn't it, as to how one reads that, both intrinsically and in the light of section, was it 84?

MR GRAY QC:

84(2)(b), Your Honour.

ELIAS CJ:

But the point made by, I'm sorry, finish that bit, you will have to come back to the point made by Justice Gault, because it may be a bit late in the day, except in response to the particular Telecom appeal, to seek something from this Court to, to say that the whole methodology has been erroneous from the start.

MR GRAY QC:

In relation to 2003 and 2004 –

ELIAS CJ:

Yes.

MR GRAY QC:

– the complaint made was the method by which –

ELIAS CJ:

Yes.

MR GRAY QC:

– the technology was employed. It may well be too late in that appeal for us to say the method was wrongly employed because of these fundamental problems, because those arguments were not made there.

ELIAS CJ:

Yes.

MR GRAY QC:

In relation to 2004/05 and 2005/06, these are the arguments which were made and which Justice Winkelmann has accepted and are reflected in Her Honour's judgment.

TIPPING J:

Well, not quite in these terms, perhaps, but you say effectively reflect?

MR GRAY QC:

Yes.

ELIAS CJ:

But I suppose you, you get there on the, if this is right, the argument that the model was applied instead of the statute, is available in respect of 03/04, irrespective of what happened earlier. Although, I suppose, in respect of the first, I'm now getting totally confused about how many determinations we have, but in respect of the one that was in issue in the Court of Appeal, the President's approach was that the methodology didn't accord with the statute and it should go back.

MR GRAY QC:
Yes, for reconsideration.

ELIAS CJ:
For reconsideration.

MR GRAY QC:
To be candid, what Young J does not do in his judgment is focus to the precise extent that we now are on whether the word "an" in the definition must, as Telecom has submitted in this Court, mean that Telecom is to be ignored and the provider is to be treated as wholly hypothetical, so that existing, already recovered assets and the fact of their recovery is to be ignored and all investments are to be treated as new, or whether the word "an" encompasses both the general and the particular –

TIPPING J:
Well, it has to encompass the general.

MR GRAY QC:
It has to encompass the general. Whether it also encompasses the particular.

TIPPING J:
Well, when you apply a definition, subject to context, you apply it in the way which you consider best serves the purpose and policy of the Act –

MR GRAY QC:
Yes.

TIPPING J:
– and you, I suppose, are saying that because of the rather bizarre consequence, it, of a wholly fictional situation, it should be read as encompassing when applied, "the" as well as "an"?

MR GRAY QC:
Yes we do, and we also say –

TIPPING J:

But this, you see, it troubles me too, I mean, it may be procedurally, technically sound that you're raising this in reply, but if I were Mr Hodder I think I'd be getting a bit agitated.

MR GRAY QC:

I'm not implying, Sir.

ELIAS CJ:

But he looks very calm.

TIPPING J:

Oh, well, Mr Hodder always looks, but I may be being unfair, Mr –

MR GRAY QC:

I'm not replying, Sir.

TIPPING J:

– What are you actual – you're not replying?

MR GRAY QC:

No, no, I'm respondent in 04/05 and 05/06. This is my principal argument on those appeals.

ELIAS CJ:

And Mr Hodder has a right of reply.

TIPPING J:

Yes, I appreciate that. But, yes.

MR GRAY QC:

These are the –

TIPPING J:

I accept that it's procedurally sound, it's just extremely odd that at, pretty well the end of a four-day hearing, we find this fundamental point suddenly emerging?

BLANCHARD J:

Well, it sometimes does in a response.

ELIAS CJ:

Well, I must say I had thought that this was a point, although how it fits in with the appeals I'm not quite sure, but it's the issue that I was really asking about, in terms of the top-down methodology.

TIPPING J:

I'm sure it's my fault, and I'm not criticising you at all Mr Gray, I, it's just that it really is, perhaps it's just a very terse encapsulation of a much bigger point.

MR GRAY QC:

Part of the problem, and if there's any fault I'm sure it's mine, but collectively we are coming to understand this problem and it is a formidable –

TIPPING J:

Well, yes, but that is absolutely no criticism, please don't think that, I was really just sort of thinking aloud.

MR GRAY QC:

Can I say this? This topic is not, in anyone's submissions, wholly real world or wholly hypothetical, every submission depends on a blend of the real and the hypothetical. Telecom wants its real world network, its core network to be accepted.

TIPPING J:

It wants the best of both worlds?

MR GRAY QC:

Well, we both do. I'm not going to say that my learned friend does and I don't. The answer is yes it does, as do I.

TIPPING J:

Well, you both do.

MR GRAY QC:

Yes we do, but Telecom says the right place to regard the real world and then to leave it is our core network and everything else is hypothetical. We say no, the policy and objects of this legislation require a consideration, both of the hypothetical and the particular, both the generic and the particular.

TIPPING J:

Assuming you're right, that you can't really raise it in relation to that first, or whatever it is year, if you're right for the second years when you can raise it, it would have to go completely back to the Commission, wouldn't it, it would be a completely new drawing board?

MR GRAY QC:

Trying not to smile, yes, Sir.

TIPPING J:

Well, I wouldn't start smiling, I mean, it's a big if.

BLANCHARD J:

And the beta factor would have to go back, wouldn't it, because it's an element and the Commission could hardly have it its hands tied behind its back with a set beta factor –

MR GRAY QC:

One of the reasons –

BLANCHARD J:

– in doing the reassessment?

MR GRAY QC:

One of the reasons Vodafone hasn't been actively engaged in asset beta is Vodafone asks that the matter be remitted back to the Commission and accepts that if it is, the Commission looks at the topics in the round.

TIPPING J:

Yes, you said that right at the beginning –

MR GRAY QC:

Yes.

TIPPING J:

– which is very fair and sensible.

MR GRAY QC:

And, I mean, we say it's perfectly clear that the Commission's decision that it will no longer engage in exogenous optimisation within the access network and its beta decision are inextricably linked, and cannot be separated.

TIPPING J:

So that the crunch as you hear it is what's actual and what's hypothetical?

MR GRAY QC:

Yes.

TIPPING J:

You say it's Telecom, but notionally acting efficiently and with unavoidable costs and so on?

MR GRAY QC:

Yes. And we say that the proper construction of the definition of net cost is to look to lower prices, not higher prices.

TIPPING J:

What happens if we are with you, but you can't take the point in relation to the first year, do we have to blind ourselves to the correct legal interpretation of the definition?

MR GRAY QC:

The question then becomes whether what the Commission did in that year nevertheless complies with what you have construed the statute to mean.

TIPPING J:

Well it wouldn't –

MR GRAY QC:

The complaint in the first year is not with the failure to model alternative technologies, because they were modelled, it was the manner in which they were modelled.

TIPPING J:

But they haven't done it – assuming you're right on this fundamental point, they haven't done it right at any stage.

MR GRAY QC:

We would say that's the consequence.

TIPPING J:

Yes. Well what do we do for the years when you can't take the point, just ignore the correct interpretation of the Act?

ELIAS CJ:

It wasn't an issue in the appeals before us.

MR GRAY QC:

The rights between the parties are resolved.

TIPPING J:

An even bigger mess than I thought.

MR GRAY QC:

Well, it is a significant issue.

TIPPING J:

Of course.

MR GRAY QC:

With significant sums of money involved too.

TIPPING J:

Oh look I'm not – yes.

MR GRAY QC:

Justice Blanchard, to come back to the point of the ACCC, it has issued a draft report in September 2010, you asked when was the time at which it came to consider that it was inappropriate to return recovered costs of legacy assets which are embedded within infrastructure that supplies universal service.

BLANCHARD J:

Was it dealing with a situation like this, where a new regime was being imposed upon an existing service provider?

MR GRAY QC:

It was dealing with access pricing in the context of – access to the local loop. So it was dealing with the provision of existing services, using existing infrastructure.

BLANCHARD J:

An existing network?

MR GRAY QC:

Yes. What happened is the ACCC dealt with the matter, in one way it went to the Tribunal, the Tribunal said, "No you should not be including as a component of costs the recovery of the new value of assets which have already been recovered, think about it again." And the ACCC has done so and issued a draft report dated September 2010, it's in the bundle, in volume 4 of the bundle, under tab 36. Together with the other comparative materials that show that this topic of recovering embedded costs as a component or providing universal – spreading the costs of providing universal service – is dealt with elsewhere.

TIPPING J:

As I recall it, the Commission rejected the idea of using historical costs because it said it was too difficult.

MR GRAY QC:

Yes it did.

TIPPING J:

But we don't know anything about that?

MR GRAY QC:

No. Even in the very first documents there's no detailed discussion of that.

McGRATH J:

Is there anything that we can learn from the FCC's treatments that would go to this particular matter?

MR GRAY QC:

My learned friend Mr Hodder referred you to a footnote in a Commerce Commission determination which in turn referred to paragraph in an FCC document, and the paragraph but not the whole –

McGRATH J:

We had the document, I think, in volume 4.

MR GRAY QC:

Yes.

McGRATH J:

Which does discuss embedded costs.

MR GRAY QC:

Yes it does, and we say it turns its face against recovery of embedded cost, and says that that's inefficient because it sends the wrong investment messages, and that's a 1999 report.

McGRATH J:

1997, I think.

MR GRAY QC:

Your Honour I think is right.

McGRATH J:

Now is there anything that you can on a principled basis, say, submit that would say that that assist us in interpreting this legislation?

MR GRAY QC:

No, I can't say it drives the determination, the construction of this particular statute, Your Honour, because that's what the question becomes.

McGRATH J:

There's no link at all to statutory history.

MR GRAY QC:

No, I mean from the reference in the footnote to the Commission's work we know the Commission was aware of it, but it is not possible to say that this is something that the legislature took account of or the responsible department had available to it, to drive its work in the preparation of the legislation, so far as is available on the record.

ELIAS CJ:

I wonder whether, as we started early, we might take a short adjournment, so perhaps carry on by all means if you'd like to now, otherwise we'll take a 10-minute adjournment.

COURT ADJOURNS: 11:46 AM

COURT RESUMES: 12:01 PM

ELIAS CJ:

Mr Gray.

MR GRAY QC:

Your Honour, during the adjournment we'd had an exchange which had been prompted by consideration of the 2004/05 determination, which is in volume 2, under tab 25, and we had begun at paragraph 45, my learned friend Mr Hodder has taken you to all of these paragraphs, so in the interest of time I won't ask Your Honours to look at them again, but this is the point at which the Commission articulates its understanding that to introduce what it defines as exogenous optimisation within the access network would mean that the provider suffered a net present value of its assets of less than zero, and that would be inconsistent with the interests of dynamic efficiency. And its conclusion is found on page 531, at paragraph 150. And it concludes, "The Commission considers that a TSP or a new entrant", and it's a TSP, "would expect compensation for the risks associated with stranding due to exogenous optimisation. Without such compensation either on an ex-ante or ex-post

basis, the TSP or a new entrant would have an expectation of earning a net present value of less than zero of its investment. As the Commission has not taken into account the stranding risks associated with the introduction of new technologies in the original inputs set for the TSP, the TSP is subject to an expectation that its net present value is less than zero.

"There are many possible ways in which this asymmetry could be resolved", and a reference back to a discussion at 153, "In previous determinations, the Commission has indicated that if compensation is required, it should be done on an ex post basis through cash flows. As ex post compensation for Exogenous Optimisation is in economic terms equivalent to the Commission no longer introducing any new technologies into its modelling, the Commission has discontinued Exogenous Optimisation. This is a simple and direct way of accounting for the asymmetry that would otherwise be created. The Commission has chosen the approach of no longer introducing new technologies into the TSO optimisation process, thus ensuring that the NPV=O outcome and dynamic efficiency will be achieved."

Can I make these submissions in respect of that. First, my learned friend Ms Scholtens said that modelling provision of services by mobile technology was difficult and complex and the Commission was having to work hard, the Commission does not say that is a reason for its decision. The reason for its decision is that to model exogenous technologies within the access network would result in the incumbent not recovering the 2001 value of its assets employed. That's the reason, that's why it was done. And second reason it's done is because NPV doesn't equal zero, and because that means that dynamic efficiency will not be achieved, and the dynamic efficiency is only dynamic efficiency to Telecom in respect of its decision whether or not to invest, and it treats Telecom as making a hypothetical new investment in 2001. That is the decision.

Now, we submit that Justice Winkelmann's judgment needs to be considered against that, and the criticisms made of it need to be considered against that. Her Honour's judgment is in volume 1 of the bundle, under tab 11, and it begins at paragraph 63 on page 376. Now at paragraph 63, Her Honour sets out what she interprets as the framework within which the Commission is to do its work. First Telecom has to tell the Commission what it thinks was its cost. Has to take a reasonable rate of return on incremental capital in direct and indirect revenues. And then Her Honour at 63(ii) says, "In its determination of the net cost the Commission must take into the

provision of a reasonable return on the incremental capital employed by Telecom." Her Honour construes the definition of net cost as focussing not only on the generic, but also on a particular provider.

TIPPING J:

Well, she does say that by implication, but does she actually say that expressly anywhere in the – it's by implication?

MR GRAY QC:

It's by implication, Your Honour. But in my submission when you look for the thesis that develops in the next several pages –

TIPPING J:

Oh yes, it's perfectly apparent, now that you've pointed it out, that that may well be what she was doing.

MR GRAY QC:

As counsel before I may have had some responsibility for that.

McGRATH J:

Isn't she doing that not by reference to the definition, but by reference to section 84(1)(b)?

MR GRAY QC:

In my submission, no, Your Honour, if you look at the first sentence of paragraph 64, in my submission Her Honour is synthesising as best she can the scheme of the legislation. That section 63(i) refers to section 84, section 64(ii) refers to section 5, and section 63(iii) refers to section 18. So in my submission –

McGRATH J:

When you say sections, you're referring to –

MR GRAY QC:

I'm sorry, paragraphs within her judgment.

McGRATH J:

Could you just say that again, I'm sorry?

MR GRAY QC:

In my submission what Her Honour's doing, at paragraph 63(i) –

McGRATH J:

Yes.

MR GRAY QC:

She's synthesising succinctly what she think section 84 requires.

McGRATH J:

Yes.

MR GRAY QC:

At paragraph 63(iii) her reference is to section 18.

TIPPING J:

The reference to Telecom on the fourth line of paragraph (i) is again by implication?

MR GRAY QC:

Yes.

McGRATH J:

But when she refers in 63(ii) to "employed by Telecom" –

MR GRAY QC:

Ah, I'm sorry.

McGRATH J:

– is that a reference to the coming back to section 84?

MR GRAY QC:

I'm sorry, Your Honour, I missed the question.

McGRATH J:

I'm sorry, but –

MR GRAY QC:

Justice Tipping, in paragraph 63(i) Telecom is obliged by section 83 or 4 –

TIPPING J:

Yes.

MR GRAY QC:

To provide information to the Commission.

TIPPING J:

But she's construing 84(1)(b) as being a reference to the particular provider –

MR GRAY QC:

Yes.

TIPPING J:

– not to a hypothetical provider.

MR GRAY QC:

Yes, and of course that turns on the exchange you had with my learned friend Jack Hodder that within section 84 is both a definite and an indefinite article, and the question is whether the definite article in section 84(1)(b) is subsumed by the indefinite article implied by the definition of net cost in the third line of subsection (1).

TIPPING J:

Well, the Judge here has clearly, by implication, construed it as being the particular provider.

MR GRAY QC:

And our argument on that is, as that exchange with my learned friend Mr Hodder proceeded, the observation was, although section 84(1)(b) has a definite article, it is part of subsection (1) and it's therefore part of whatever the definition of net cost requires; and if the indefinite article in net cost means only a generic provider is involved, then the definite article in section 84(1)(b) must yield.

TIPPING J:

And the requirement for specific information from the actual provider is a little odd.

MR GRAY QC:

And my submission is, that if the definition of net cost enables a consideration both of the generic and the particular, then the definite article in section 84(1)(b) can refer to the particular and the provision by the TSP of its own information is consistent with the scheme of the actual incremental capital of the provider being what is contemplated.

TIPPING J:

Well, if it was intended in section 84(1)(b) to be generic, or hypothetical, the definite article should not be there, it would just say "return on incremental capital".

MR GRAY QC:

Yes. It is not necessary that there be an article.

TIPPING J:

It's getting fairly semantic, this, but –

ELIAS CJ:

In section 84(1)(a) it's clearly a reference to the costs of this specific provider, surely consistently section 84(1)(b) is also the costs of this specific provider, and this is why I raised whether in fact the structure of the Act doesn't envisage that there will be a top-down approach, that you will look at the actual costs and then bring in the discount to ensure that you're using an efficient provider.

MR GRAY QC:

In the preliminary stages Vodafone argued that this was a top-down process. The Commission adopted scorched node and Telecom has not – Vodafone has not challenged that until now.

ELIAS CJ:

No, but it's –

MR GRAY QC:

But our submission is that top-down –

ELIAS CJ:

But it is top-down, insofar as it applies to the core network, effectively. As Justice William Young says, there's a bottom-up in terms of the node onwards, but there is a

top-down being applied in respect of the network. But, whatever, it does seem to me that section 84(1)(a) and (b) are perfectly consistently interpreted as looking to the actual costs of the provider, the actual provider.

MR GRAY QC:

We say the consequence of that is that the word "an" in net cost, must encompass both the generic and the particular, and cannot be limited only to a hypothetical generic.

ELIAS CJ:

Well, in the end you've got to come up with something that is hypothetical, necessarily, don't you? Because you have to make the provider efficient within the meaning of the Act.

TIPPING J:

If they're already efficient –

ELIAS CJ:

Oh yes, well then you'd get –

TIPPING J:

– you may not have to?

ELIAS CJ:

No, absolutely.

MR GRAY QC:

The question in this case is whether the result of enabling the provider to recover its hypothetical 2001 new investment is contemplated by the statute, is consistent with the text and the scheme and the purpose of the statute, and we say it isn't.

ELIAS CJ:

Yes, I understand that.

MR GRAY QC:

But –

ELIAS CJ:

I thought we were really having this discussion because of what Justice Winkelmann says in para 63.

MR GRAY QC:

We are, Your Honour, and we say Her Honour is right where she says in paragraph 63(ii) that the legislation contemplates "a reasonable return on the incremental capital employed by Telecom in providing the services." And then Her Honour goes on at paragraph 64 to explain what she understands to be the scheme of the legislation, and we understand that that description is orthodox and is consistent with what the Commission itself has concluded in its preliminary work and determinations.

BLANCHARD J:

Does this approach mean throwing out completely optimised replacement cost? Or does an historical cost approach, actual depreciated cost, approach in 2001 have to somehow get melded into optimised replacement cost?

MR GRAY QC:

The Commission considered whether to adopt optimised replacement cost or depreciated optimised replacement cost, and we say this approach means the Commission should have adopted the latter.

TIPPING J:

The set-up has got to accommodate both an existing provider as of the date of commencement of the scheme and a future provider, does it? Well, it's someone who comes in?

BLANCHARD J:

Well it's the same person, it's looking at it at different times.

TIPPING J:

Well it may be a different person.

BLANCHARD J:

But that might involve different considerations.

TIPPING J:

Yes, but I'm just wondering whether the problem here is that it's been looked at as if it's a new provider, when actually it's got to accommodate the fact that there was already a provider there.

MR GRAY QC:

Yes. But the problem with the approach is that it treats any provider whether new or existing as if it is new, and it says that it has to do that, both because a construction of the definition of net cost prevents consideration of the particular, and also because dynamic efficiency or incentives for investment will be not achieved if something else is done. And we say both of those are wrong.

TIPPING J:

But the incentivisation, logically perhaps, only goes as to future investment.

MR GRAY QC:

Yes.

TIPPING J:

Investment within the scheme, not investment that's taken place before the scheme comes into place, may be an argument. It doesn't harm you.

MR GRAY QC:

No.

BLANCHARD J:

Mr Gray, can you help me by explaining optimised depreciated replacement cost?

ELIAS CJ:

Where does that appear?

MR GRAY QC:

Oh, I'm going to ask Ms Ferguson.

BLANCHARD J:

It is mentioned fleetingly in 2001/2002, but I don't recall how it works.

TIPPING J:

It's depreciated optimised isn't it, rather than optimised depreciated, is it? I'm not sure.

MR GRAY QC:

Thank you, my learned friend says it's at page 1026. In the implementation. Yes, it begins at page 1025, Your Honour, I'm grateful to my learned friend. "Optimised replacement cost is the present-day cost of acquiring an asset to efficiently provide the required quantity and quality of service. Replacement cost is based on current market values and is given the availability of current –"

TIPPING J:

My brother was right, I was wrong, it is optimised depreciated, not the other way around.

MR GRAY QC:

And what complicates things is they go on to talk about optimised deprival value, so that acronyms become confusingly similar.

TIPPING J:

So you take an asset in at replacement cost, which may be higher, or in many cases, lower, and then you write off it any depreciation that's actually been claimed or allowed in respect of that asset in the past, is that correct?

MR GRAY QC:

Yes. What slightly confuses me, Your Honour, is at paragraph 186 the Commission refers to the FCC analysis that forward-looking economic costs are the best measure, but doesn't seem to take account of that part of the FCC's work that we looked at earlier that expressed the view that recovery of embedded costs would not be efficient because it would send the wrong investment signals.

BLANCHARD J:

Well, we've looked at it very fleetingly.

MR GRAY QC:

Yes, and we can't do much more, because all we thought fit to include was the extract that had the paragraph referred to by the Commission.

BLANCHARD J:

But we've got the whole thing.

MR GRAY QC:

No, you've only got the extract –

BLANCHARD J:

Well, it's the larger extract.

MR GRAY QC:

Yes.

BLANCHARD J:

Because we had a quick look at it, well, it's in one of the bundles.

MR GRAY QC:

It was in our bundle, Sir, 4 under tab 34.

ELIAS CJ:

There isn't a tab 34.

BLANCHARD J:

Yes there is.

ELIAS CJ:

Oh authorities, is it? All right.

MR GRAY QC:

And if Your Honours will note on page 122, paragraph 224, is the paragraph relied on by the Commission in paragraph 186.

TIPPING J:

Sorry, I've lost it now. Which page are you on?

MR GRAY QC:

In tab 34, Sir.

TIPPING J:

In volume 4?

MR GRAY QC:

Yes. Paragraph 224, "Use of forward-looking economic cost" is the paragraph that the Commission has included in its implementation paper issues paper, that we were just looking at, on page 1028 of the case, at paragraph 186.

TIPPING J:

Just before we move to that, does the Commission's discussion paper say anything more about ODRC than the very brief one-liner in paragraph 177?

MR GRAY QC:

I don't believe it does, Sir.

TIPPING J:

And they don't go back and explain why that's inappropriate?

MR GRAY QC:

I'm not aware of anything, Sir, I will check.

TIPPING J:

Paragraph 180 appears to be suggesting that they'd previously said it, it didn't have any clear advantages over historic cost.

MR GRAY QC:

It does say that, Sir, and it seems to treat depreciated costs, whether optimised or otherwise, as a species of historic costs, and to conclude that optimised replacement cost is forward-looking and therefore preferable, and refers in paragraph 180 to its work in respect of other industries. The point I was going to make, Your Honour, is that at 186, the Commission –

ELIAS CJ:

But don't you have to go on to 181, or maybe it's not part of your argument, because they depart from it in the case of telecommunications and TSO services.

MR GRAY QC:

They do that, Your Honour, in paragraph 182, they say, "The ACCC says that because telecommunications are changing so much –"

ELIAS CJ:

I see.

MR GRAY QC:

"Historical cost isn't helpful", and they go at 186 to talk about what the FCC has done –

ELIAS CJ:

Yes, I see.

MR GRAY QC:

– and they adopt 224, but what they don't do is go over to consider 227 and 228 and footnote 580 of what the FCC has said, which is that recovery of a carrier's historic loop or switching costs would send the wrong signals.

Now, we were considering Her Honour Justice Winkelmann's judgment, we'd been looking at paragraph 64, at her articulation of the scheme of the Act, and at paragraph 65 she goes on to say, "the use of the efficient service provider standard is a mechanism to encourage Telecom to provide its services efficiently by depriving Telecom of the ability to recover its inefficiently incurred costs. The unavoidable net incremental costs to the efficient service provider must therefore be intended to act as an upper limit or cap on the costs recoverable under these provisions." So Her Honour construes the scheme, including the definition of net cost, as incentivising low-cost delivery. She then concludes at paragraph 66 that "It seems unlikely the model developed by the Commission was ever well designed to function as a cap or check on the actual costs that Telecom was able to recover from other liable persons under the Act." And that's the first point at which the phrase "actual costs" occurs, and it was the subject of some criticism by counsel for Telecom on the basis she had misdirected herself as to the costs that the legislation required the Commission to

consider. We say Her Honour got it right. We say the legislation does require consideration of the capital actually employed by Telecom and a reasonable rate of return on that. And the legislation doesn't mandate the things that we are here complaining about today. So we resist the criticism of Her Honour's judgment, and say that in fact the use of that phrase "actual costs" shows that Her Honour had correctly construed the statute. Criticism was then made of the final sentence at paragraph 66, where Her Honour said, well, I note the Court of Appeal judgment seems to have had a different view, but that judgment doesn't determine the matters before me.

It was said that Her Honour was being disobedient there, that in fact the decisions of this Court of Appeal had determined the issue. We say Her Honour is correct. That the Court of Appeal was dealing with the method by which the Commission had employed mobile technology in its cap in 2003 and 04, Her Honour was dealing with a much different question. The larger and wider question, whether achievement of net present value equals zero was central to the task being performed by the Commission under the legislation, and indeed so central that anything which prevented achievement of that return was inconsistent with the statute, and we say the Court of Appeal judgments do not determine that question and Her Honour was quite right to say so. And the first line of paragraph –

BLANCHARD J:

You're not really arguing against NPV=O, are you?

MR GRAY QC:

Not for new investments, Sir, or for unrecovered investment.

BLANCHARD J:

Yes. You're concentrating on what present value is?

MR GRAY QC:

Yes. That's correct, Your Honour. And that's the point picked up by Her Honour in the first sentence of paragraph 67, that the model now employed by the Commission assumes a level of new capital investment, or unrecovered capital investment, not made, and we say Her Honour's quite right. Her Honour rightly then notes that, the initial determination was on that basis and that was wrong. And she goes on to say, "On an ongoing basis, the modern equivalent asset valuation methodology utilised by

the Commission may also result in more capital being ascribed to Telecom's TSO operations than actually employed by it – a modern-day equivalent may well cost more than the original asset did at the time of purchase." Now, while it's true that switching equipment will become cheaper, the cost of digging trenches in stony ground, and the Commission has acknowledged that's a very large part of the cost base, is not likely to become cheaper, and therefore she concludes that "The modelling approach therefore risks providing more than a reasonable return on the capital Telecom actually uses". Doesn't conclude that it does, says that the model's inappropriate because it contains that risk.

At paragraph 68 she rightly describes what the Commission has concluded, and in the second sentence rightly notes that the Commission is treating Telecom in this part, as wholly hypothetical, and says at paragraph 69 in doing what the Commission's done in ceasing to introduce new technology, the Commission no longer does what the legislation requires, it no longer models net cost. She goes on to say, "Its sole focus has become ensuring NPV=O", and as Your Honours have seen from the determination that's precisely what the Commission did. She makes the point at the conclusion of that sentence, that return of NPV is not a substitute for the balancing required by the legislation. And comes on at paragraph 70 to deal with the topic of new investment.

At paragraph 72 she notes that when you rule out the introduction of new efficient technologies there is a "guarantee of return", the Commission had submitted to the contrary but she rejects that submission and noted that in the prior year the Commission had said that to adopt NPV=O would be to guarantee a rate of return, and as we've seen what the Commission also said was that to do so would be inconsistent with the legislation. Her Honour refers to, at the end of paragraph 72, to the exercise being annual and therefore intended to capture current costs, whereas what the Commission has done by adopting a network in year 1, employing assets that may last for 20 years, has effectively locked in time what the provision will be and what the costs will be. Possibly obviating the need for annual assessments.

Then she picks up, or said something consistent with the submission we've made. "the Commission has viewed efficiency predominantly from a perspective of Telecom". She says, first, Telecom should be incentivised to invest in new technology, but the point that is implicit in what she's saying is the Commission also has to consider the efficiency interests of other participants in the industry and what is a proxy for a process of competition in relation to these services.

TIPPING J:

Now you're coming to paragraph 74?

MR GRAY QC:

Yes. That's where she picks up the position of competitors, Your Honour.

TIPPING J:

Well the first sentence in 74 is not complete, is it?

MR GRAY QC:

Well, I interpret what Her Honour's saying there is, it's not consistent with the scheme or the text or the purposes of the legislation to pay Telecom more than its actual costs –

AUDIO STOPS: 12.34 PM
COURT RESUMES: 12.39 PM

ELIAS CJ:

Thank you. Thank you, Mr Gray.

MR GRAY QC:

Thank you, Your Honour. As we have noted, Your Honours, at paragraph 74, Her Honour includes in her consideration of efficiencies to be considered the competitors and any competitive disadvantage that may arise from competitors having to pay too much to Telecom, and we say that's an issue that arises properly by section 18, subsection (1), of the Act, and then Her Honour sets out her conclusions at paragraph 75. A sentence which had caused some difficulty when this decision was being discussed with my learned friend Mr Hodder is in paragraph 71 and is the second sentence, "Consideration of efficiency must entail consideration of the least cost method of provision of service inherent in which, of course, is an assessment of the ramifications of historic investment decisions for overall cost analysis." In my submission, what Her Honour is saying there is it is legitimate for the Commission to have regard to the long-term nature of investments and infrastructure in this area, and it is legitimate for the Commission to have regard to investments having been

made in the past, but efficiently made, and I understand that's what Her Honour means by the phrase "ramifications of historic investment decisions".

So in my submission Her Honour's showing that she's aware of the concerns which have been expressed by Telecom and discussed many times by the Commission that an efficient service provider will make investment decisions which have consequences over time, and it shows that Her Honour is not blind to that, but has it within her thinking as she develops what she understands to be the correct evaluation of the extent to which what the Commission has done complies with the statute.

So we say that Her Honour is not only permitted but required by the statute to consider the actual position of Telecom, and correct to do so, and that the criticisms of her judgment made by reference to her use of the phrase "actual cost", are misplaced. That's our respectful submission. And we say that Her Honour was right to remit the matter back to the Commission, and the Commission will have a free hand when it does. And we say that Her Honour, with respect, obtained the right balance between real world and hypothetical world. As I've submitted earlier in answer to a question from His Honour Justice Tipping, there is inevitably, in this field, elements of both. Both parties advocate elements of both, they just do it differently. Telecom wants a hypothetical value for its investment, but it's the real location of its switches and cables. That's Telecom's balance.

Our balance focuses principally on the access network and says the access network should be modelled using technology that was seen by the Commerce Commission in its preliminary work to be becoming available, modelled by the Commission and accepted by the Commission as being capable of providing service in the prior year and overlaid. And Vodafone says that that is another part of the real world which must be considered, and if the consequence of considering it is to connect the calls to a different part of Telecom's core network, with the further consequence that parts of Telecom's core network are no longer employed for making those services available, although may be employed for making others, so be it, that is what the real world, the word "unavoidable" and the word "efficient" require.

Now ,there has been some controversy, Your Honours, about the extent to which overlaid networks could, when the Commission modelled them in 2003 and 2004, have provided service. One of the curious things about this process is that

commercial confidentiality means that advisers to Vodafone are not entitled to see details of Telecom's network and are not capable therefore of modelling it. So that what they do is model Vodafone's network and make the assumption that Telecom's competing network is likely to be broadly the same. But the modelling that was done by Vodafone's experts of the coverage offered by the Vodafone network at the relevant time led to a conclusion that 70% of commercial non-viable customers were within coverage in 2003 and 2004. Now that is not to say that 70% of customers could more cheaply be served using mobile technology. It may well be that for some of the coverage the quality of service, while available, wasn't sufficient to meet TSO deed requirements, and it may well be that further investment would've been required to enable that. But it's just a question of how many customers might sensibly have been able to be served by that technology when it was made available.

The Commission records Vodafone's experts submissions in its determination, which is found at volume 1, tab 6, page 253, at paragraph 697, and the report itself is found at volume 9, tab 97, page 4010.

BLANCHARD J:

Could you give me those page numbers again please?

MR GRAY QC:

Of course, Your Honour, it's volume 1 of the case, under tab 6, at page 253 for the report, the precise figure is at paragraph 697, and volume 9, tab 97, at page 4010 for the report, which is referred to by the Commission.

GAULT J:

4010 did you say?

MR GRAY QC:

That's correct, Your Honour. Now that concludes, Your Honours, my submissions in respect of the 2004/05, and 2005/06 determinations and the judgment of Justice Winkelmann. In fact, the passage in volume 1 that I've taken you to is convenient, because I have one point to make in reply to my learned friend Mr Hodder in relation to 2003/04. And it is this.

My learned friend Mr Hodder, on this question, in response to a question asked by Justice Blanchard, "Well how many people could have been serviced by mobile

technology at the relevant time?" referred Your Honour to paragraph 711, at page 257, and said by reference to that paragraph, "Well in fact everything needed to be adapted, and it's not clear that many at all could be served." That paragraph is found within appendix 9 of the Commission's determination, which begins on page 253. Appendix 9 is a review of the extent to which mobile technology was capable of providing service and could do so more cheaply. As I've said, Network Strategies Limited for Vodafone reported in respect of Vodafone's technology because it could not do otherwise, it couldn't report in respect of Telecom's because it didn't have the detail that enabled it to do so.

But at 704 the Commission set out its view of the existing networks. The Commission specified performance parameters, and those are the parameters that are derived from the TSO Deed which binds Telecom. There's then a discussion of competing submissions and the Commission's conclusions begin at paragraph 728 when it comments on the Network Strategies Ltd design. Its view is that the wireless cap designed by Network Strategies may provide service to a significant proportion of the ESA, and the ESA is a sample being considered.

BLANCHARD J:

I'm sorry, I've lost the paragraph number?

MR GRAY QC:

I'm sorry, Your Honour, 728. The sample being considered is Waimarama. So the Commission says at 728, well it can provide service to a significant proportion of it. And at 729 it's received a hypothesis that it can do that much more cheaply than in the model, but what it says at 733 is the Commission's modelling requirement is that a design be provided that will optimise the scorched node but no more than the node. Though the "within coverage" model, that is the model of what to do when there's an overlaid network, is not specifically based on providing service to scorched nodes, it's closer to scorched earth which the Commission has rejected. The Commission has accepted that it should use New Zealand available prices for the implementation of the wireless cap and that's one of the factors that's increased the cost of the radio caps.

And then, in summary, "The Commission has accepted that a GSM technologies cap if correctly designed can provide TSO service. The implementation of the cap in the 'within coverage' model has not been demonstrated. The 'outside coverage' model

does not provide an adequate level of service to all the customers". And the reason for that is summarised at paragraph 753. "In any case the model's design philosophy does not match that of the Commission's requirements. Each ESA should stand alone in isolation. In instances where it was technically possible for more than one ESA to be serviced from the same location then this site could not be looked on as a common cost as it's been assumed in the NSL model. Each of the ESA would have to individually bear the full cost of developing the site. This has ensured that each ESA is costed on the basis of a virtual small scale build out from each local exchange". So what the Commission did was completely ignore existing infrastructure, model –

ELIAS CJ:

Mobile infrastructure?

MR GRAY QC:

Yes, yes. Model the construction of a wholly new network based around the switch, sometimes requiring multiple transmitters in order to guarantee the grade of service, and even doing that where clusters are next to each other so that an antenna can provide service to both, it ignores the efficiency available from using an antenna to service both, and requires each cluster to be modelled on a standalone basis. And what that does is substantially increase the cost of the model service by requiring the construction of more antenna, more roads, more access, more services than are required in the real world, or even are required in a hypothetical world when the true nature of mobile technology is understood. So when my learned friend Mr Hodder said by reference to paragraph 711, well it's not clear from the Commission's work the extent to which services could be provided using mobile technology, in fact what this shows is that the Commission did not, in 2003-04, model what was on the ground, did not employ mobile technology according to its own characteristics and what it could do and have an excessively artificial view of the way in which mobile technologies could be used, a view driven by its determination to keep the local switch in place and to route all calls through the local switch.

TIPPING J:

Could I come to the question that I was asking when I spoke to the recording system, Mr Gray? If your submission about the correct approach, the definition and that sort of thing, is sound, would the exercise the Commission had to undertake be very much less complicated and sophisticated, it would simply look at the actual cost and

then say whether there were any efficiencies or inefficiencies or costs that were avoidable and adjust accordingly?

MR GRAY QC:

Your Honour might think that would happen, but it ignores the parties' abilities to disagree over what the historical cost is.

TIPPING J:

I see. Well, given that –

MR GRAY QC:

Yes.

TIPPING J:

– yes, given that, well I think the parties disagree about almost anything, everything but given that premise, the actual concept would be very straightforward.

MR GRAY QC:

We say the concept is more straightforward but there might be difficulties in the doing of it.

TIPPING J:

There might be difficulties, there'd still be some, some variables or some issues –

MR GRAY QC:

Yes.

TIPPING J:

– but they'd be vastly more straightforward than what we have in front of us.

MR GRAY QC:

We say so, Your Honour, yes.

TIPPING J:

And that would be the effect, you would submit, of adopting your legal submission?

MR GRAY QC:

That's correct, Your Honour.

TIPPING J:

Thank you.

MR GRAY QC:

You can look at what's there, you can identify what more needs to be there to provide the service.

TIPPING J:

You start from the actual and then you adjust to reflect the requirements of the –

MR GRAY QC:

Yes.

TIPPING J:

– of the definition?

MR GRAY QC:

Indeed, Your Honour. Your Honour, I will be only 10 minutes or so after the luncheon adjournment.

ELIAS CJ:

That's fine. I should indicate that the Court can sit tomorrow, and we wouldn't intend to sit beyond four today unless we were close to finishing.

MR GRAY QC:

As Your Honour pleases.

COURT ADJOURNS: 12.58 PM

COURT RESUMES: 2:14 PM

MR GRAY QC:

Unless Your Honours have any questions I have no further submissions.

ELIAS CJ:

Thank you, Mr Gray.

MS SCHOLTENS QC:

Your Honours, just one point, in my role as aiming to assist the Court, if there is some question about whether the Commission, why the Commission chose optimised replacement costs valuation as opposed to optimised depreciation replacement cost or historic cost, we haven't prepared submissions on that basis and the record wasn't prepared, taking into account all the material on that issue and if, and I'm certainly not inviting the Court to go there, but if the Court does wish to investigate that question, we could provide more material and explanation.

ELIAS CJ:

Right. Yes, I think me may need that and you might like to consider before we end whether that would mean you'd want to address us on it as well, or whether the material can simply be supplied. Thank you.

MS SCHOLTENS QC:

Thank you, Your Honour.

BLANCHARD J:

Of course other counsel may need to –

ELIAS CJ:

Oh yes, I mean that, everyone having a go.

BLANCHARD J:

No, but they may need to put in at least written submissions, depending on what it reveals.

ELIAS CJ:

Yes, Mr Hodder.

MR HODDER:

Did I mention that I thought Justice McGechan had the simple answer to most of these matters?

ELIAS CJ:

Yes, you did.

MR HODDER:

Yes, okay, so that's really the first submission repeated.

TIPPING J:

Still an attractive submission, Mr Hodder.

MR HODDER:

I was hoping it might be after four days of this. The second one is Lord Mustill was right, that's a slightly longer statement, to the same practical effect on most of the issues, and the third one is going to require a bit more time, which I guess is where I am at the moment. I have been contemplating my learned friend's submissions and the point, the two points I've just been making slightly facetiously are partly encapsulated in the exchange he had with the Court just before lunch, where he's asked, "Well does this mean you go back to the Commission, that it all goes back to the Commission?" And he said, "Well yes, you do, and the Commission will have a free hand." Really? You'll have a free hand, but it seems it can't have chosen optimised replacement cost, somehow or other that seems to be an error of law. It can't have chosen NPV=O because that seems to be part of it, and it can't have chosen scorched node, and so the question in general that I invite the Court to consider in this context is whether each of those constraints, i.e. that means the Commission doesn't have a free hand, are required by law, i.e. by the terms of the statute. And obviously our answer is they are not.

So it's probably simplest if I go straight to the statute, perhaps – I'm going to address the issues of my learned friend Mr Gray, who's been addressing, and I'll deal with the question of asset beta at the end, but it's probably best if I tackle it by going back to the words of the statute we're talking about, and in particular the point that Her Honour the Chief Justice was exposing for submissions in relation to section 84. We really only have a limited number of parts to the Act where the wording is crucial, but I do stress, as I did in our opening submissions, that the whole of the Act, or rather the whole of Part 3 of the Act, is significant and provides the context with the particular words, but the particular words we are focusing on for our practical purposes are probably section 92, because that's the one that says what the Commission's supposed to do, and that's why we're all here. Has it made a determination that includes the net cost to the TSP of complying with the TSO instrument during the financial year. Section 84, which is the one that explains what

the considerations are and to determining net cost, and of course the definition in section 5. Can I just, for a moment, although I think the starting point is actually in section 92, and then working through section 84 to section 5.

Can we just start for a moment with the section 5 definition again, just to identify that it does incorporate a number of concepts, all of which, in our submission, require choices. So the definition means the unavoidable net incremental costs, and I'll come back to net, to an efficient service provider. So the word "efficient" is one there that has, as we say, a number of possibilities of how one goes about it, in providing the TSO services, or the service required by the TSO instrument, to commercially non-viable customers. Now, none of those concepts are straight forward, in our submission, none of them is easily amenable to an elaboration of a definitive kind from a Court, and if I start at the back, there is the point that a commercially non-viable customer is a concept which is elusive and, as my learned friend Ms Scholtens explained to the Court, the way in which the Commission goes about it avoids having to go through and do a survey of each customer because it's the end result of the outworking rather than the beginning of it.

But can I say that the top-down approach which has been suggested as possibly available here requires a bottom-up approach to CNVCs, you'd have to actually go down and kind of count them and count their respective demands on the system and their contributions to the system because the way in which the existing methodology has done won't work if one doesn't have a system such as the one that's been used by the Commission to produce –

ELIAS CJ:

You'll explain that a bit more, will you?

MR HODDER:

Well if – you can either have a system, as my learned friend explained, where you, you don't start with – by knowing what the number of CNVCs is, you work it out as an assumption from the interplay of costs, so you don't have to know that in a particular ESA somewhere outside Invercargill there are four people who are not commercially viable and six people who are, you don't have to go down to that detail. If you start from a different position that says we need to know who these CNVCs are before we figure out what the cost of them is, then you don't have that – as it were – luxury, you'd have to come up with something completely different –

ELIAS CJ:

But you don't know who they are until you've worked out whether – what the costs are.

MR HODDER:

Well, then you have the, well, it partly depends on the usage rates –

ELIAS CJ:

Yes.

MR HODDER:

– so you'd probably be able to work out some kind of averaging across –

ELIAS CJ:

Yes.

MR HODDER:

– the utility and their demands on the network and so on and so forth. So I don't, I can't take the point too far, it wasn't a matter that was discussed in the evidence in any great detail because it wasn't, it hasn't been considered by the Commission in that way, it was rejected, although that's sort of where both Vodafone and Telecom started. But the point for present purposes is that this isn't a simply exercise. With respect to, I think, Justice Tipping's observation, I don't know that we're going to simplify the process substantially by saying you can't, you can't use the current methodology, go back and find a nice simple one by just applying the definition, the definition itself –

TIPPING J:

But you may not be able to simplify that aspect of it?

MR HODDER:

Well, I'll come to the others as well, I hope to persuade you that none of them are simple. So the CNVCs is itself a problem which – one we haven't focused or spent a long time on, but in our submission it does – the efficient service provider in the phrase "an efficient service provider" is, in our submission, at the heart of it and again

our submission is it's not amenable to more precise definition, there are a whole series of questions which have to be answered and choices that have to be made.

TIPPING J:

Why, in this case, does it not mean Telecom acting efficiently?

ELIAS CJ:

Do you mean lowest cost?

TIPPING J:

Well, whatever "efficiently" means.

MR HODDER:

Well that's the part of the problem.

TIPPING J:

Yes I know that's part of the problem, but how much of this is hypothetical and how much of this is actual? Mr Gray said that you both say it's a bit of both but you differ on which parts.

MR HODDER:

We say it is essentially hypothetical, but the purpose of the part which requires dynamic efficiency and therefore incentives to the TSP provider, whomever that may be, require there not be too big a risk and a gap between the actual cost in the TSP and the notional cost that a TSP has, otherwise you don't have anybody turning up when you want to have a TSO service.

TIPPING J:

So the difference between you, is you say it's essentially hypothetical and, if Mr Gray will forgive me, he says it's essentially actual.

MR HODDER:

That may be what he's saying, I –

TIPPING J:

There's no need to put it like that, Mr Hodder.

MR HODDER:

But I'm – no I'm not saying that, Sir – I'm not – I don't know that he's saying quite that, but I don't want to rephrase his submissions for him, I'm not saying I don't understand what he's saying, that's not it at all. So I don't know that he's saying just that. He's saying there's a balance in there somewhere and the language of the Statute dictates that it's not where the Commission has drawn it. Our proposition is there is undoubtedly some non-definable, not easily definable line in there which the Commission has to make a series of choices about, that it isn't open to a definition.

TIPPING J:

But it is open to the dichotomy, and this is the point surely, as to whether it means essentially a hypothetical service provider or essentially Telecom but acting efficiently.

MR HODDER:

Well, if that is the choice, then our answer is essentially an efficient service provider, which is a hypothetical construct.

ELIAS CJ:

It's a – you say it's a – a new entrant effectively, do you?

MR HODDER:

Not necessarily. The TSP will have a history if it's providing the TSO service over a period of time, but it's a notional provider of services over a period of time so the "new entrant" phrase is perhaps not, not the most pertinent.

ELIAS CJ:

Well I meant the – it's done as if it were a new entrant?

MR HODDER:

Yes. Yes.

ELIAS CJ:

And as if the new entrant were putting up the capital that it brings in. I mean –

MR HODDER:

Yes, yes.

ELIAS CJ:

– the network.

MR HODDER:

Yes, yes because that capital has a value. One of the points that is obviously underpinning much of the discussion is the choice about how you decide what the capital value of the assets is. But the accounting value of the assets is not the same thing as the utilisation value of the assets –

ELIAS CJ:

Yes.

MR HODDER:

– their value and the opportunity cost, which is perhaps the most appropriate consideration here, reflects the value that can be attracted from them, not what the accounting principles say. So –

ELIAS CJ:

So is that, is that the difference between accounting value and economic value?

MR HODDER:

Yes.

ELIAS CJ:

Yes. Which I think was the question earlier on –

MR HODDER:

Well, sorry – as I understand it.

ELIAS CJ:

– that someone was raising. Yes, that's as I understand it.

MR HODDER:

And it is discussed in the way that you were taken to this morning, I think it's in one of the earlier implementation papers –

ELIAS CJ:

Yes.

MR HODDER:

– which is – the choice is made. So, just if I can just explain the point that hasn't – I don't know if it's been completely addressed thus far, what we say is one has to ask the net cost of what, that is the cost of providing the services. Those services will involve a capital component. A capital component, the cost of the capital component, is legitimately regarded as including opportunity cost, and that's one of the ways in which the Commission justifies its choice of optimised values rather than historically depreciated values. All our argument has to say, and does say, is they had a choice, and we say that it is not easy to find anything in the statute, in any of the sections we're talking about, that drives the conclusion that they could not make that choice. All of this comes into the concepts of – and it's the composite phrase – the net cost of providing the TO service, the TSO service of an efficient service provider. But even if you had a new entrant, the new entrant will have to have capital and it will hope soon to recover the capital and a return on the capital. So NPV=0 is not something which is biased in favour of Telecom, it will apply to anybody, nor shall it discriminate against a party that's using older assets if they have a current opportunity cost or an economic value.

Now, as I say in the end, with respect, we say it's not for the Court to determine that particular choice. That's a matter for the Commission. As long as the Commission has made a reasonable choice in those areas, then that's a matter for it and in the – making that choice, we say that it's entitled and expressively directed to have regard to section 18, we've been through the efficiency variations including dynamic efficiency. How you best apply dynamic efficiency and incentivise it, again we say must be a matter of a choice, it isn't –

ELIAS CJ:

Dynamic efficiency is not the only purpose of section 18, is it?

MR HODDER:

No. But there's a balance between it and the others. I fully accept that, as I understand –

ELIAS CJ:

Yes.

MR HODDER:

– the Commission does, so the question is how do you balance dynamic efficiency, and is the Commission entitled to say it's the most important level of efficiency in this area with the other static efficiency considerations, and again we say that's not amenable to determination as a question of law. And the way in which it goes about that comes back to the incentive effect. The incentive effect applies, as we said at the outset, to the full TSO regime. If you were going to have a TSO regime which is phrased in general terms, then it's not going to work if the proposition is that the regulatory regime takes away economic value, and that's precisely what the submissions for Vodafone require. There is an economic value in the assets that are in question here. Whether they've been historically depreciated for accounting purposes or not. If you take it away, what TSP is going to have confidence in that regime to go further? And so we say that is the overall purpose, which again the Commission explicitly has regard to and we say it was entitled to.

BLANCHARD J:

How closely does optimised replacement cost approach opportunity cost? Is there a relationship?

MR HODDER:

Um, if I can just preface this by a slight diversion. Your Honour's comments yesterday reminded me of that Churchillian phrase about America and Britain being divided by a common language, it's a bit like that with economics and law, so I am not an economist as the Court's well aware, but I understand that what you might do in the scenario, is postulate, "What would a new entrant do?" A new entrant would come in with optimised replacement cost assets, if you can make the thought experiment around that, in that the way the opportunity cost and the ORC would approximate I would've thought.

ELIAS CJ:

But is that what is applied to Telecom's case? Does it come in with optimised assets? On the asset –

MR HODDER:

Yes, the thought experiment is, well, not quite, because of the scorched node approach, but it's still an optimised version of the core network as well as the full optimisation of the access network. So if you can hypothesise away the existing network, then what would come in would be what would be, what the best that a new entrant could do, constrained in the core network by where the location and the – make sure the general assets are –

TIPPING J:

So there is some constraint from the actual?

MR HODDER:

In the scorched node approach, yes.

ELIAS CJ:

Well in terms of the scorched – effectively it, effectively you've got scorched earth for the node onwards and you've got – no, scorched earth for that –

MR HODDER:

Yes.

ELIAS CJ:

And I'm just struggling to see what you've got for the core, for the core network would you say you have an optimised –

MR HODDER:

Yes, because on a value and replacement cost basis, and if there are better and cheaper parts of the core network, then that's what you get assessed on, and that's one of the incentives to efficiency that's retained in the scorched node model. If it was convenient, I was then going to –

ELIAS CJ:

Sorry, does that mean, not that we have to, but it has to be accepted that replacement value is optimised value? Yes?

MR HODDER:

Replacement value?

ELIAS CJ:

Sorry, what did you say?

MR HODDER:

It was optimised replacement costs.

ELIAS CJ:

Optimised replacement costs.

MR HODDER:

Yes, means they're the best way you can replace or the most efficient way you can replace that particular asset.

ELIAS CJ:

Oh I see.

MR HODDER:

And so, I'm not sure, I think probably using metaphors is going to get me into trouble, so one can hypothesise some equipment will be cheaper and more efficient than its predecessor, but serves exactly the same function.

ELIAS CJ:

Yes.

MR HODDER:

That's what you use.

BLANCHARD J:

I think the difficulty we're struggling with is that there's a gap in the case as it's been presented to us, and there hasn't been enough focus on this fundamental question of how you should best value the assets for compliance with the statute. And Ms Scholtens is going to provide us with the missing material.

MR HODDER:

Well, we say it's an inevitable gap, because the Court's concerned with a question of law, and the gap we're talking about is a valuation gap.

BLANCHARD J:

Yes.

MR HODDER:

And so, the essence of the submissions of Vodafone appears to be that it was legitimate to choose optimised replacement cost, it was necessary to go back to depreciated historical cost, as a matter of law. And of course our response is it's a matter of valuation choice, which the Commission has gone through a series of processes since 2002, and formed its view upon. That's why there's a gap, because that particular issue, i.e. that it didn't have a choice to choose optimised replacement cost, hasn't really been highlighted up to this point. And, sorry, just to complete the circle on my submission or response to Justice Blanchard, it was because this really is a question of law case, it's not a question about valuation methodology, except at the outer extremes.

Your Honours, I was going to turn to section 84 –

McGRATH J:

Just before you go, to what extent did the choice of Commission depend on the report of August 2001 by the Auckland University Centre to the Ministry of Economic Development?

MR HODDER:

Well, we don't know that precisely, Sir, that report is footnoted, as you recall, on the Cornerstones paper that follows it, and then that Cornerstone reasoning is adopted, but it's been the subject of the various consultative phrases the Commission's been engaged in – trying to attribute who the victory was owed to, or who can claim the victory for the ultimate conclusion, isn't clear. I mean one can track a direct line of intellectual reasoning from that paper through –

McGRATH J:

Yes.

MR HODDER:

But whether it was supported by, or ever became, a major resistance along the way, is not a matter we've traversed in this hearing. I was going to address section 84, if that was convenient.

The proposition that Her Honour the Chief Justice was putting forward is that section 84(1)(a) is about the real world, the real TSP, and therefore section 84(1)(b) must be also. In our submission that doesn't necessarily follow, and the premise was itself explored in the early work of the Commission, so can I invite the Court to have a look at volume 2 of the case on appeal, at tab 30.

ELIAS CJ:

What are you taking us to?

MR HODDER:

Volume 2, tab 30.

ELIAS CJ:

No, no, I just mean, what is it?

MR HODDER:

It's the Cornerstone paper.

ELIAS CJ:

Of course.

MR HODDER:

At page 970, the Court will have recognised of course, 969 and 970, where we've been a couple of times before, in the choice between scorched node or scorched earth, but we haven't gone to the next choice, which is relevant to section 84(1)(a), which is to use actual hypothetical revenues, I think I mentioned in passing a couple of days ago. What the Commission does, and we say is a perfectly reasonable argument, is to explain, if it has an efficient service provider, it should be efficient both as to costs and to revenues, because the word "net" becomes important in the definition of net cost. It also becomes important in the context of the

calculations of benefits. And what the Commission goes through and says is, "Is it appropriate to recess the revenues", which it starts discussing from 168, goes through and gives some examples. And in the end it concludes that it won't exactly model Telecom's revenues. It won't accept Telecom's revenues, and that's what you find on page 972, from paragraphs 175 through to 176. It says, "Where Telecom chooses not to increase the line rental, it will treat it as if it has increased the line rental." So it moves, is prepared to move away from an actual, to, as it were, a notional revenue. And if one looks also at 84(1)(a), that's a reference to associated benefits. I don't know this is an issue that arises for our purposes, but there may be a series of associated benefits, not all of which are taken into account by the actual TSP, but if an efficient TSP had taken account of them, then they may be inappropriate for the calculation.

TIPPING J:

Mr Hodder, I may be being terse, but 167, bottom of page 970, seems to suggest that you start from the actual and then adjust for inefficiencies.

MR HODDER:

In this particular discussion it's doing that, yes. It actually says, it has the choice over the page, Sir, in the last couple of lines, adjusting the actual cost downwards or using the external data.

TIPPING J:

Yes.

MR HODDER:

Which is the alternative.

TIPPING J:

But you only do that if you don't think the actual are the product of efficiency, is how I understood this, but probably I'm wrong.

MR HODDER:

Well, I don't know any of us can say, Sir, it's simply an observation that there are choices, and the first one mentioned is the actual, the second one is using the external data.

TIPPING J:

Yes, but it seems to be on the premise that you only adjust if there is, according – it seems here that where the Commission perceives the TSP to be inefficient, it should adjust. But if it's efficient, then it seems implicit that you don't adjust.

MR HODDER:

That's what that sentence says, Sir, I agree. I don't know that's what was ever intended to be subject to the degree of scrutiny we're subjecting it to now.

TIPPING J:

Well, all right.

ELIAS CJ:

What about paragraph 178, its preliminary conclusions?

MR HODDER:

Yes, we say that's the choice the Commission is making. Actually it's two choices. Essentially it will use the actual revenues, but at one point it will depart from those.

ELIAS CJ:

In using the maximum line rental allowed?

MR HODDER:

It deems Telecom in this case to have more rentals than actually received. More rental dollars than actually received. The same point is dealt with in the position paper, which I'll take the Court to, but the reference is in volume 3 of the case, tab 33, at page 1136. I better check that that's the right page number.

ELIAS CJ:

Volume 3?

MR HODDER:

Volume 3, tab 33, 1136 beginning at paragraph 76, but it's essentially the same matters it traversed in paragraph 76 to 81, and that approach is carried on. So we respectfully submit that one can't take section 84 as assuming an actual TSP in either (a) or (b) in terms of what it's being addressed to.

ELIAS CJ:

But that's where you end up. It's only taking into account, it's starting with it, that's required by 84.

MR HODDER:

That, in our submission, isn't at all plain from the language.

ELIAS CJ:

Oh.

MR HODDER:

The net cost under section 92 is the net cost of an efficient service provider.

ELIAS CJ:

Sorry, I'm not making myself clear. I was talking about section 84.

MR HODDER:

And I am too, Ma'am. The driving proposition for our purposes is accompanied in the net cost under section 92, which is the net cost of an efficient service provider, the following matters must be taken into account. So here we are with a final determination, required to comply with section 92, and that is determining the net cost, i.e. as defined being that of an efficient service provider. Nowhere, with respect, do we see that it says the net cost of the actual TSP.

TIPPING J:

Well, the words "to the TSP" are a bit misleading then. It should say the net costs, just simply of complying with, if that was what it meant.

ELIAS CJ:

I don't have a problem with that, that referring to the, to "a" TSP in 92. It's the distinction would seem to me in 84 is that although it's for purposes of determining the net cost, the Commission has to take into account the actual position.

MR HODDER:

Well, obviously –

ELIAS CJ:

Which is really what they decide that they're going to do anyway, only they then come up with a different, with a slightly – they don't accept it, but they take it into account.

MR HODDER:

Yes, and nothing that we're arguing says they can't take it into account. In fact we say they must take it into account.

ELIAS CJ:

Right.

MR HODDER:

Because, going back to my original incentive proposition, if you don't take into account what's happening with the real TSP then the gap between a real TSP and the notional TSP gets too wide and gets incentivised.

ELIAS CJ:

Yes, yes.

MR HODDER:

So you can't have –

ELIAS CJ:

But – well maybe we're at cross-purposes, because the only point I was trying to make was that the same is true, surely, of 84(1)(b)?

MR HODDER:

Well I imagine there's a sort of semantic impasse to some extent there, Your Honour. Nowhere in (a) or (b) does it say the actual TSP or the actual capital or the actual revenues. All of them are phrased in a neutral way which can apply either way, and our submission is there's nothing in there to signal that it must be read as focusing primarily on the actual revenues or the actual costs of the actual TSP.

ELIAS CJ:

That's not the end position they have to reach in determining what is the net cost, but they are required, surely, on this to take into account the actual cost in arriving at the net cost. That's the proposition –

MR HODDER:

It is.

ELIAS CJ:

– I'm putting to you.

MR HODDER:

And the response is that, this is going to sound very tedious, but this is a matter of choice. The choice then does require actually doing some work on the TSP's actual costs. I meant actual detailed work.

ELIAS CJ:

But just a moment ago you said that they have to take some account of the actual cost because otherwise there will be a widening disconnect between actual and hypothetical.

MR HODDER:

At a level, that can be at a reasonably high level of extraction, so that one can see that there are or are not incentives.

ELIAS CJ:

I think there's too much high-level extraction here. But all right, maybe you're not necessarily disagreeing with me. You're saying it's a matter of choice.

MR HODDER:

I am.

ELIAS CJ:

I am raising that it looks quite consistent with – this is an information provision section that the actual costs need to be taken into account. I know you say it's a matter of choice. They can or they can't.

MR HODDER:

Because the actual may not be – the tasks that the Commission is given under Part 3 is to come up with a net cost to an efficient service provider. The question that we are currently addressing is whether section 84 says as part of that task you must understand and know and identify the actual costs of the TSP. Now I resist that as a matter of law. I say that in general terms, having some appreciation of the costs is important for incentive effects but I resist the proposition that it's necessary for the Commission to model the actual costs.

ELIAS CJ:

I see. Thank you.

TIPPING J:

Why is there reference in 88 to "unreasonably prejudice the commercial position of the TSP" because they, that clearly demonstrates, doesn't it, that there's going to be material about the actual TSP's financial circumstances.

MR HODDER:

Yes.

TIPPING J:

Which supports –

MR HODDER:

Or there may be.

TIPPING J:

Well they may be, yes.

MR HODDER:

So it's a quid pro quo in a sense where the requirement to provide accurate information at the risk of some pain under section 82, you must give –

TIPPING J:

Well why do they have to – it's obvious, isn't it, that if they have to provide actual information, they have to do so because the Commission has to at least consider it and have regard to it?

MR HODDER:

Well, I particularly would see it the other way round, Sir, but if the Commission decides it needs actual information as opposed to information according to some model of its own, then when that's provided it has a confidentiality aspect to it, there's a protection of that under section 88.

BLANCHARD J:

So it's there in case the Commission makes that choice?

MR HODDER:

Yes. Now there are – I think I've probably addressed most of the main points that I wished to. I realise one could torture these words forever, but I'm not sure I'm doing much but repeating what I said in my initial submissions at this stage.

The proposition – perhaps I should address the point about "unavoidable". On that one I think His Honour Justice Tipping defined the issue down to we are now concerned did the Commission direct itself that unavoidable added nothing to the definition, and as I apprehended that, that's very close to the issue, or the definition of the issue that we are, and our answer to that is no, and which we endorse essentially the reasoning of Justice Arnold for the reasons he gave. But again we would say it's important not to focus – and the way the question was framed doesn't – not to focus on the word "unavoidable" in isolation. It's part of a composite phrase which, as I was attempting to discuss earlier, has a series of imprecise concepts embedded in the net cost definition. And then what my learned friend, as I noted it went on to say was, what it's really meaning is you must do it the cheapest way. But as soon as we get to the word cheapest we start to get into the questions of cheapest in the short term or the long term, and what are the efficiencies, considerations arise out of that and all of which I'm sorry to say again takes us back to a series of choices which are really for the Commission.

TIPPING J:

What do you say about section 83(a) Mr Hodder? It casts an obligation on the TSP to tell the Commission what it thinks the net cost is?

MR HODDER:

I think we traversed that somewhat the other day, so, yes, our submission is that section 83 requires it to produce information in accordance with the Commission's requirements. It's both in 83 and it's also in 84(3), "Must comply with any

requirements... relating to the information it provides," and I took the Court to, I think it's in volume 5 and tab 50, the letter where the Commission says, "You will provide us with information in accordance with our model and using our WACC." That has nothing to do with what Telecom thinks its own net cost is, as the Court's aware Telecom thinks its net cost is somewhere north of twice what the Commission thinks it is. So 83 is in accordance with the requirements.

TIPPING J:

It's all really governed by the requirements of the Commission?

MR HODDER:

Yes.

MR HODDER:

Which is, we would say, a perfectly sensible part of the overall regime, it's not much good the party that has some detailed information giving information to suit it, when the Commission has decided to take a different approach, legitimately, and is not getting the information it wants.

ELIAS CJ:

Well is it going to get any information under this, or is it simply going to get economic submissions?

MR HODDER:

Um, that's a very fair question, I'm not sure I need to answer it, I think it's a rhetorical question, isn't it Ma'am?

ELIAS CJ:

Well, they're not going to get hard information are they? Except maybe on the map of the network if –

MR HODDER:

Well, as we saw before in the discussion, it makes, because revenues are actual, the sort of things that you can account much more readily than costs.

ELIAS CJ:

Well, I don't know, I think we should have hypothetical revenues if we're going to have hypothetical assets.

MR HODDER:

Well we do in part, as we know.

ELIAS CJ:

Yes.

MR HODDER:

All we have to do is just look at temptations, say, in the real world. It's easier to identify revenues than costs, of ones coming down to the last telephone line or whatever it might be, the revenues are more readily accountable and therefore more likely to be the matters you would seek information on, and likewise where the customer locations are, those are factual matters, and that no doubt can be fairly described as information. As soon as we start looking at economic costs, the word "information" might be slightly more problematic.

TIPPING J:

I think what you're saying, Mr Hodder, on the definition, and I'm sorry to jump around, is that whichever way we read it, you should get to the same result.

MR HODDER:

Yes, Sir.

TIPPING J:

Is that really what you're saying? Yes. Whether "an" should be read as generic, or whether it's applied as specific, you should, by whatever route, up, down, backwards, forwards, get to the same result.

MR HODDER:

You should.

TIPPING J:

Or the Commission is entitled?

MR HODDER:

Correct. There's a journey to be taken –

TIPPING J:

Yes.

MR HODDER:

– to get to the end result, and it's up to the Commission which particular route it travels, that would capture our submission.

McGRATH J:

Mr Hodder, your position seems to be pretty close on this part of his judgment to Justice William Young, and just if you'd like to look at paragraph 46, at page 22 of the first volume.

MR HODDER:

I'm sorry, Sir, which paragraph of the President's judgment?

McGRATH J:

At paragraph 46 of the Court of Appeal judgment.

MR HODDER:

This is where the President talks about the mixed signals?

McGRATH J:

Yes.

MR HODDER:

Yes. Oh, 45 he talks about the mixed signals.

McGRATH J:

Exactly, that's what he does at 45 –

MR HODDER:

Yes.

McGRATH J:

– I was looking at 46, and I've just – I think that 47, probably, is that one way of summing up your position? Never mind those difficult provisions in the statute that appear to be looking at existing infrastructure, come back to net cost and focus on efficient service provider.

MR HODDER:

Yes, if I could add a gloss to the President's paragraph 47 it would be that it envisages an objective test based on an efficient operator, but informed by what the actual TSP is doing is –

ELIAS CJ:

What, constrained by its present configuration?

MR HODDER:

If, unless that sends outrageously inefficient – yes, that would seem reasonable. But again, I'm sorry, that's a choice for the Commission.

McGRATH J:

Well, that's fine, you've put that tag on 47, so I'll just ask you about 48, how far will you go with the President there?

MR HODDER:

Well I agree down to the hast sentence quite comfortably, and I don't think I have any difficulty with the last sentence, our proposition is not that scorched node is embedded in the Act, but that scorched node is one of the choices available to the Commission.

McGRATH J:

Well, I think you said it was a matter of judgment when you went through this initially.

MR HODDER:

Yes.

McGRATH J:

Yes.

MR HODDER:

Well that's right, the language that is used in both the *South Yorkshire* line of judgments and in Justice Arnold's judgment, there's a sort of an interplay between evaluations, judgments and choices. I think they're all saying the same thing, that there is a matter where the Commission is entitled to form a view about these matters, within the bounds of reasonableness.

McGRATH J:

Thank you.

MR HODDER:

Your Honours, unless there are questions in relation to those aspects of the modelling, that I was going to turn to the question of the asset beta and respond if I might to some of the comments in the approach advanced in relation to that from the Commissioner. On the basis that I might save a little time, I have reduced my comments on that, outlined them on a page, if I could hand that up through the Registrar. The main thing I wanted to do in relation to this was respond to my learned friend Ms Scholtens' reference to the 2002/2003 determination, which I haven't touched on, so I had spent some time talking to you about 2001/2002, she declined to talk about that, I declined to talk about 2002 and 03, but I guess I'm forced to do so at this point, so that's the purpose of this exercise. So what my note is designed to do, is to pick up some of the issues between the 2002/03 and 2001/02 determinations.

Now, I fully understand that I'm in that difficult position where I have said too often that this is a matter of choice and judgment evaluation for the Commission.

ELIAS CJ:

And then now you're going the other way.

MR HODDER:

Unaccustomed as I am to saying that, but there is a margin of appreciation, and we say that the Commission in relation to the asset beta point has gone over it, and the Court of course understands, I'm sure, where I am coming from. So the first point that I make is that the 2002/03 determination and the reference in my first line is, obviously, to volume 5, tab 58, page 2289, it isn't in any way disowning the 2001/2002 determination, and the reason I spent some time stressing the 2001/02

determination is that was a process that took a considerable period of time. It comes out at 70, I think three years after the legislation is enacted, and the Commission's been working in this area for quite some time, solidly, so they've had the earlier papers, there's the special WACCs paper and there's various other bits and pieces, so this is not – the 2001/02 is the first time the Commission brings all its thinking together. If it had got it wrong, then it might've said in 2002/03, "Well, we're actually sorry about that, we just put that to one side, and we're going to start afresh." But it doesn't do that. And as I've given references in from the 2002/03 determination, it says, "It's a cross-check". Well, a cross-check says, "Was our first one right? Is there something wrong with it?" And the answer is, "No." And then it says, "In the end we get to it and say 0.4 is an appropriate beta because they're consistent between 2001/02, 2003/04." So to the extent –

McGRATH J:

It also talks about it being an alternative approach, doesn't it?

MR HODDER:

It uses those words.

McGRATH J:

Cross-checks, has a more subsidiary sound to it, but the alternative approach and the particular reference to the PSTN beta – it seems to me you might be indicating it was a bit more of a substantial exercise.

MR HODDER:

I think we acknowledge it was a substantial cross-check, but just after the passage Your Honour's referring to is where it says, "Well, in the end our ultimate conclusion is that both of these are consistent with each other." And I think Your Honour's probably referring to those, around about 198, 199, where it says again, "Well it used an alternative approach".

McGRATH J:

I think there's more back at 171.

MR HODDER:

Well, 198 uses the phrase, it says, "We've used an alternative approach to arriving at the TSO asset beta... The Commission considers that both of these approaches produce a range of beta estimates which are generally consistent."

McGRATH J:

But that's really a conclusion which just follows from the earlier discussion, doesn't it, it's – that's part of which is 171, that's what I – where they say that "the Commissioner believes that this alternative approach to beta estimation for the purpose of the TSO represents a useful cross-check... reflects the view expressed earlier, that various approaches can be taken to estimating asset betas, and that there is value in considering these approaches together, rather than relying on any one methodology."

MR HODDER:

Yes. I don't know we're disagreeing with each other, Your Honour, and it undoubtedly says that, it's undoubtedly put these approaches together and says they are consistent, the results are consistent. My point is essentially that they haven't in any way resiled from the first one, including the logic of the first one, and that what our concern is is that if one follows the logic of the first one, then there is a gap.

So, just very quickly, proposition 2 is what is said by the Commission since at least its early WACC paper. Only non-diversifiable risk is relevant to the beta, and we recall that we're talking about the expected compliance or achievement of returns, consistent with the economy as a whole, or the market as a w hole. And so if you can diversify into a wider range of investments, then that's a risk that you can remove from a unique investment and it's because it comes from corporate finance theory, that's the answer to the unique risk of a particular business or enterprise or asset. So no real dispute about that.

The next point is we say there is a fairly serious understatement in paragraph 151 of the 2002/03 determination, where the Commission says "The Commission also placed some weight on US electricity utilities as suitable comparators." And I've abbreviated US electricity utilities to an almost unpronounceable acronym for the purposes of keeping this brief on the page. But what, in paragraph 4, I've attempted to do is to revisit the 2001/02 reasoning. Now, I took the Court to all these paragraphs in my earlier submissions, but in our submission there's no doubt that when it came to the alternative decision, which is at 236/237 of the earlier 2001

determination, which is in volume 4, tab 48, USEUs were the prime comparator, that's where the 0.3 came from . There was also distinct recognition they don't have a capital risk because they use historical cost. They've got – but they are obviously regulated, so there's obviously a regulatory error incorporated in their risks somewhere, and that's why – sorry the report also says that that risk is reduced because there's annual reviews by the regulator, and that's one of the reasons why the US firms were comparative, because they too were revisited each year. And so that's where we get the 0.3 from.

Then, at 4.5, the systematic risk for the TSO was largely on the revenue side, that is to say, getting the discount rate wrong. That's what was identified as a regulatory risk in the 2001/2 report. Conversely, the stranding risk was thought to be largely non-systematic, it was asset specific. You could diversify away from it. And then of course, Sir, is we think the stranding risk is addressed in the annuity tilt, and they did. They also accepted the annuity tilt would include a risk of error. That was okay, provided it was a nonbiased or symmetric risk. The problem they discovered was, it was asymmetric. And I've given the references there also, back in the implementation paper, which is carried forward. And then they added an industry effect, and the industry effect, as I read the relevant part of the report, is on the basis that, if you have an absolute unavoidable utility, perhaps water might be the best example, then it's got nothing to do with the economy, people have to drink roughly the same amount of water every day, so it doesn't have much to do with marketing fortunes and electricity, the proposition is relatively close to that, because it is, as we know, difficult to survive, according to our expectations of electricity. Telecom's come somewhere further up the optional scale and said, "Therefore it's closer to the normal market activity" which is why you give it a higher ranking. Now, remember we're talking about a comparison with the US Electricity Regulated Utility, and so that's why, as I read it, they decided that in addition to the 0.3 for electricity, because this is Telecom's, you'd add another 0.1.

There's also reference there to the fact that there's an annual regulatory review, and there wasn't going to be much risk from the optimisation of values exercise. And I've given the references there again. And so, having gone through that, they get to where they are and then there's a separate discussion that comes a little later, really, that says, which leads up into paragraph 352, "No, we're not going to give an additional increment on top of the WACC through these risks, but we think you've got it sufficiently covered." On one side of the equation you've got the asset beta, on the

other side of the equation you've got tilted annuities, and this is where most of the stranding risk is going to be dealt with, and that's the point where we say the problem arises, because that, with respect, is a perfectly reasonable approach to take, we have no criticism of that. But in 2002/03 it says, "The capital risk is sheeted home in regulatory optimisation", that becomes a little unclear where that fits into the previous analysis. And then it says, "If we remove the asset optimisation and included new capital expenditure, there would be almost no capital risk." But if you remove asset optimisation and you include new capital expenditure, you're doing exactly what happens in the US electricity firms. And I've given the reference to 226, the description of why the US firms would be useful, uses virtually that language.

If you assume that asset optimisation and capital expenditure are non-diversifiable, it says, the needs would be good comparators. In any event it says in 2002/03 we think the systematic capital risks are quite limited. And, again, not too much argument with that, but then we get to the point that instead of having got it right in terms of the balance and the combination of the beta and the tilt, they discover they've got the tilt wrong, because the rate of depreciation is asymmetrical, or the risk of depreciation through new technology is asymmetrical. And so logically you would either build up something in relation to the tilt, that's terribly complicated, or you'd do something to improve, i.e. increase, the asset beta to compensate, and at that point we say there is a "does not compute" moment. How do you get to reduce the asset beta in those circumstances? And so we ask the questions in 8, to which we suggest it's not easy to find the answers. Why is the regulatory risk for a TSO undiversifiable? The TSO is a collection of assets, or a business, but it's unique. Why is the TSO regulatory risk less than for the US firms? That is, after the 0.2, at which point they're in the same position, i.e. they have not got a capital risk, but there's still some regulatory risk. And then at 8.3, if there was an error in the annuity tilt, why would you reduce the beta? If there was an error in failing to add an increment to the beta or the WACC, again, why would you reduce the beta to correct it? And then when you stand back from it, given all that's been said, and all the work was done before 2001 and 02, how did the optimisation risk account for 50 percent of the 2001/02 beta at 0.4?

Now, the Court may come to the view that there are cogent to all those questions; our submissions are that there are not, and if there are not then this was unreasonable. And those are our submissions in reply on that point, subject to any questions the Court has.

ELIAS CJ:

Thank you, Mr Hodder. Thank you, counsel, for your considerable help. We will reserve our decision in this matter.

COURT ADJOURNS: 3:11 PM