

Regulatory Alert

1 April 2009

Government Broadband Investment Initiative - A Proposal with Ambitions

This Alert considers the New Zealand Government Broadband Investment Initiative - Draft Proposal for Comment ("Broadband Proposal").

The Government has unveiled its eagerly awaited draft Broadband Proposal setting out how the \$1.5 billion promised prior to the election will be invested. The Broadband Proposal is an ambitious and innovative use of a public private partnership model. However, as the economics of rolling out fibre optic networks are uncertain at this stage, and as aspects of the Broadband Proposal would seem to favour certain types of private sector partner over others it will inevitably be highly contentious. The Government now has a significant challenge to implement the Broadband Proposal with the aim of releasing initial RFPs by August.

Key features of the Broadband Proposal

The Government's objective is to accelerate the roll out of broadband to 75% of New Zealanders - being the 25 largest cities and towns down to the size of Oamaru. Roll out to rural populations will be dealt with under other schemes. The Government's investment is capped at \$1.5 billion for the first six years, focussing on delivery to businesses, schools and health services. The rationale of the scheme is to maximize the deployment of ultra-fast broadband where it is not otherwise likely to be delivered on commercial terms.

The investment will be in open access "dark fibre" networks, which is the deployment of the fibre optic cable and passive network equipment. Wholesalers will then "light up" the network by attaching their own equipment, or, if they prefer, they can purchase services such as unbundled bitstream.

The Crown's investment will be managed by a new Crown owned investment company called the Crown Fibre Investment Company ("CFIC"), which will co-invest with the "private sector". The "private sector" is defined as any entity outside central government and would include, for example, local government. The CFIC will be required to operate open, transparent and competitive tenders for all partnerships in particular regions. However, this will not be an "all or nothing" tender process for deployment, as the CFIC may have ongoing negotiations with providers and may request further proposals at different stages. This is to accommodate the risk that no proposals may be received in particular areas, and to allow roll out in stages.

The partnership model will require the CFIC and private sector partner (or partners) to establish a new joint venture "Local Fibre Company" ("LFC") to deploy and sell access to the fibre in the region. Up to 50% of the funding for the LFCs will come from the Crown. A shareholder agreement will define the relationship between the Crown and private sector partners. There will be a model shareholder agreement, containing some provisions that are "set in stone".

"The partnership model will require the CFIC and private sector partner (or partners) to establish a new joint venture "Local Fibre Company" to deploy and sell access to the fibre in the region."

A true investment model

The Broadband Proposal emphasises that the Government's contribution is an investment, and not a grant or suspensory loan. The Government will therefore take a share of the benefits if and when any of the fibre operations become "highly profitable". On the other hand, the Government will not guarantee a return to its investment partners.

A key incentive for private investment is the ability to negotiate equity rights in favour of the private sector partner. That could include the Government's shareholding being subject to a lower rate of return for up to 10 years.

Eligibility and selection criteria

One significant restriction on the eligibility of parties to participate as partners in LFCs is in relation to telecommunications businesses that own or operate a telecommunications retail operation. In order to participate, such a party must either:

- » fully divest itself of the retail operation; or
- » it must not have sufficient control over an LFC to appoint the majority of directors to the Board. Further, the Chair of the Board of LFC must be independent and agreed to by all shareholders.

This means that if New Zealand's major vertically integrated telecommunications businesses wish to participate in the scheme as drafted, then they would likely be required to include some other private partner in the LFC in order to dilute their control. If New Zealand's major vertically integrated telecommunications businesses wish to participate in the scheme as drafted, then they would need to consider their options for diluting control. For example, including another private partner in the LFC may be a more attractive option than the LFC constitution being structured so that the CFIC partner holds sufficient appointment powers to appoint a majority to the Board. The argument for the restriction is that the level playing field provided by open access is threatened if the LFC is controlled by a specific business that is also a retailer of services.

The CFIC must apply set criteria when selecting proposals, including:

- » the "additionality" of the proposal, which means the number of end users able to benefit from new fibre who cannot readily access existing fibre, or who cannot access existing fibre on competitive terms;
- » commercial viability of the proposal;
- » ability of the proposed network to support unbundled fibre access;
- » the track record of the applicant; and
- » the target of achieving a proportionate spread of funding across regions.

Other regulatory matters

The Broadband Proposal is clear that there will be no restrictions or requirements on pricing, which will be determined by commercial decisions of the LFC's Boards. This is because:

By keeping the new fibre business out of retailing, it will have no incentive to act anti-competitively, and there will be little need for regulation of its prices.

However the Telecommunications Act 2001 and Part 4 of the Commerce Act 1986 apply (there will be no regulatory

holiday), which means it is possible to regulate services under those Acts in the future (following inquiries by the Commerce Commission). Ultimately, however, the Government decides whether to regulate a service under either Act, and it will no doubt be seeking to provide comfort to prospective partners that any fears of future regulatory intervention are unwarranted.

The Broadband Proposal also signals that the Government will be prepared to make other legislative reforms to facilitate efficient roll out using existing infrastructure. Officials will report on how best to facilitate access to, and use of: deployment on existing telecommunications and power poles; microtrenching; local government infrastructure; and fibre optic cable drops from street-side into customer premises.

"The Broadband Proposal also signals that the Government will be prepared to make other legislative reforms to facilitate efficient roll out using existing infrastructure."

Discussion

The Broadband Proposal raises various regulatory issues. We highlight just a few.

Government control of CFIC

The Government is not proposing to introduce legislation to implement the Broadband Proposal at this stage. That means CFIC will be established without any statutory functions and objectives, and will also not be a crown-owned company under the Crown Entities Act 2004. Instead, it will be listed in Schedule 4 of the Public Finance Act 1989 (by Order in Council). Putting aside whether that is an appropriate approach, the key consequence is that the CFIC will not enjoy the same statutory operational independence as other crown-owned companies, such as TVNZ. Indeed, the Broadband Proposal notes that this approach "enables a degree of Ministerial control". That is understandable given the amounts of money involved and the social objectives at stake, but potential partners should bear in mind that they will not be dealing with a fully commercial and independent entity.

Further, it is not clear whether the Crown sees itself as an active or passive partner in the networks that it invests in. If the Crown is keen to use the LFC vehicle to actively push its social policy agendas now and in the future, then that could have a significant impact on the desirability of the partnership for a private sector player.

From the Crown's perspective, one significant point is that if the CFIC is in effect nothing more than an ordinary company (with no special exemptions), then the Commerce Act 1986 applies in respect of its activities.

Constraints on LFCs

Similarly, an LFC will not be free to operate as a true private sector business. An LFC's commercial incentives will be subject to two mandatory overarching objectives:

- » To maximize availability of additional fibre infrastructure to potential end-users and retail service providers within the relevant region; and
- » To comply with matters agreed between the CFIC and the private sector partner in the shareholders agreement.

"[A]n LFC will not be free to operate as a true private sector business. An LFC's commercial incentives will be subject to two mandatory overarching objectives."

The constitution of each LFC will also contain the following Government "bottom lines":

- » It must not provide retail services; and
- » It must deploy additional fibre in the region; provide open access to the network on equivalent terms; and offer wholesale access to "dark fibre", meaning that the LFC must offer access to the passive fibre free from any electronics or value adds.

As has been reported in the media, these requirements clearly favour some providers over others. Many of the largest existing telecommunications companies in New Zealand have both wholesale and retail arms. Also, existing telecommunication companies do not normally offer access to "dark fibre". The Broadband Proposal may therefore be viewed as a push to further restructure telecommunications markets by creating a new market and by creating opportunities for new players to deploy network infrastructure.

The Minister has emphasised that the new Crown funded network is intended to provide a service to the entire telecommunications industry, rather than compete with it. Although the Broadband Proposal anticipates "opposition by existing telcos", it also notes that they will be able to submit proposals for some or all of the regions (presumably only if they put forward a proposal that waters down their control interest though), and all will be able to access the new network. However, it is difficult to imagine that the "existing telcos" will stand aside if they are not picked to be a shareholder in the LFC for a region, or if the terms of participation in an LFC are unpalatable. The "existing telcos" may have their own plans to deploy in the same regions and inevitably they may seek to roll out to the best locations before any new LFC does. The consequences of such an outcome need to be carefully thought through.

Fibre to the home?

National's election policy was to invest in fibre to the home. It appears that the Government has softened that approach somewhat, as evidenced by the following features of the Broadband Proposal:

- » The government expects the proposals to provide coverage to health and education end users plus concentrated business regions. Homes are at the bottom of the priority list.
- » It is certainly not an explicit criterion that networks provided by an LFC must roll fibre out to the home in every instance. For example, the private partner may only be prepared to roll out fibre to the cabinet. If there is a requirement to roll out to the home, it is unclear when that investment must occur. This is a key point because the business case for a partnership with Government may turn on the nature of the network that must be rolled out and at what point various parts of the network must be rolled out.

"If there is a requirement to roll out to the home, it is unclear when that investment must occur. This is a key point because the business case for a partnership with Government may turn on the nature of the network that must be rolled out and at what point various parts of the network must be rolled out."

Conclusion

The real test for the Broadband Proposal is the level of interest it attracts from potential private partners. That remains to be seen. A particular challenge is whether it is palatable for the "existing telcos" with retail arms, because in some regions they may be the only businesses with the scale and scope advantages to make the roll out of a network feasible. There is also an intrinsic risk in shutting "existing telcos" out of the LFC tent as commercially it may make sense for the "existing telcos" to deploy to the best locations within a region, before any LFC arrives.

"A particular challenge is whether it is palatable for the "existing telcos" with retail arms, because in some regions they may be the only businesses with the scale and scope advantages to make the roll out of a network feasible."

Submissions are sought on the Broadband Proposal and also for expressions of interest in participating in the initiative. It is asked that submitters follow the structure of the Broadband Proposal when making submissions. The deadline is 27 April 2009.

REGULATORY CONTACTS:

Andrew Peterson

Partner, Auckland

andrew.peterson@russellmcveagh.com

DDI: + 64 9 367 8315

Mobile: +64 (0) 27 560 5021

Pat Bowler

Partner, Wellington

pat.bowler@russellmcveagh.com

DDI: + 64 4 819 7500

Mobile: +64 (0) 27 442 8040

Tim Clarke

Partner, Wellington

tim.clarke@russellmcveagh.com

DDI: + 64 4 819 7532

Mobile: +64 (0) 27 224 5843

Sarah Keene

Partner, Auckland

sarah.keene@russellmcveagh.com

DDI: + 64 9 367 8133

Mobile: +64 (0) 27 535 5034

James Every-Palmer

Partner, Wellington

james.everypalmer@russellmcveagh.com

DDI: + 64 4 819 7370

Mobile: +64 (0) 27 580 1616

Nicola Purvis

Consultant, Wellington

nicola.purvis@russellmcveagh.com

DDI: + 64 4 819 7750

Mobile: +64 (0) 27 248 8012

Derek Johnston

Partner, Wellington

derek.johnston@russellmcveagh.com

DDI: + 64 4 819 7535

Mobile: +64 (0) 27 446 6848

David Clarke

Partner, Wellington

david.clarke@russellmcveagh.com

DDI: + 64 4 819 7516

Mobile: +64 (0) 27 244 5658