18 May 2006

Hon David Cunliffe
Minister of Communications
Parliament Buildings
WELLINGTON

Dear Mr Cunliffe

Response to the Commerce Commission's Schedule 3 Investigation of Mobile Termination Reconsideration Final Report

Introduction

I am writing on behalf of the New Zealand Business Roundtable in response to the Commerce Commission's 21 April 2006 Reconsideration Report (Reconsideration Report) concerning the regulation of fixed line calls to mobile phones. The Business Roundtable is an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

In our letter to you on this topic in December 2005, we stressed the need to apply a burden of proof to proposals that could have a chilling effect on investment in infrastructure. Key concerns in this respect are proposals that:

- are not demonstrably in the national interest;
- increase uncertainty about future government actions; and
- take property rights from infrastructure investors without good reason or compensation.

National interest

A fundamental test of whether a policy promotes the national interest is whether its assessed benefits to citizens exceed the costs. An accepted approach is to add the net benefits to the public as consumers to the net benefits to the public as producers. This process nets out the effects of transfers of wealth between individuals that create no overall net gain for the community. Net gains are sometimes called efficiency gains. This approach is also in the long-term interests of consumers since, given market competition, such gains ultimately flow to them.

The analysis in the Reconsideration Report establishes that the proposed regulation of mobile termination does not produce clear net gains. The calculated net public benefits in table A2 of the Reconsideration Report are either +$4.745 million or -$4.752 million. Neither figure is significantly different from zero, given estimation errors, and provide no basis for a policy change.

We are concerned that the executive summary of the Reconsideration Report fails to report these calculations. Instead it makes the grossly misleading statement that its cost-benefit analysis produces "a net benefit over a five year period of between $46 million and $63 million in present value terms". This statement only takes into account the estimated shortterm gains to consumers and excludes longer-term losses to consumers arising from reduced incentives to invest further out. Nor does this section make clear that these numbers ignore the costs the public will incur during this period as investors, producers and suppliers. The estimated consumer benefits ($46-63 million over 5 years) are extremely small and, given estimation uncertainties, could well be not significantly different from zero. They could be dwarfed by even a small percentage drop in the sharemarket values of major telecommunications companies (an indicator of losses in producer surplus). The implication is that the overall public interest was not a material consideration in the Commissioner's recommendation.

The critical issue for the national interest in this area is the preservation of incentives to invest in infrastructure and new technologies. Since 2001, three new mobile networks (two by Telecom, one by Vodafone) have been launched in New Zealand. The community would be worse off today without these investments, regardless of any monopoly pricing issues. The focus on transferring wealth at the margin between producers and consumers ignores the overall national interest.

The Commission has undermined its credibility by failing to provide a national interest justification for its actions. Since the new technology is still being rolled out at a cost of hundreds of millions of dollars, it is impossible for the Commission to establish that any future charges for access will be excessive in relation to marginal cost or average cost. Future demand is unobservable, as is the future rate of economic depreciation.

The real intention of the Commission is apparently to benefit the public, as fixed line customers, by an estimated $191 million (in NPV terms) while costing the public, as mobile phone customers, up to $125 million. Other costs to the public interest roughly account for the balance. Yet, such transfers, for no clear overall benefit, make no sense in terms of equity or efficiency.

The Commission's evident refusal to acknowledge the relevance of costs to the community as suppliers of labour and other inputs, providers and investors is also at odds with its earlier approach. For example, in the Auckland airport case it explicitly acknowledged that transfers that benefit one party at the expense of another provided no community benefit *per se*.

Uncertainty about future regulatory actions

The Reconsideration Report effectively dismisses the likely adverse effect of the proposed regulation on future investment in 3G and on other new telecommunication technologies. It considers this risk:

> … to be small given that regulation is linked to circumstances where clear market power exists, intervention is likely to promote competition for the long-term benefit of end-users and pricing practice recognises the need for investors to obtain a reasonable return. In addition, the service for which regulation is proposed (termination of mobile voice calls) is not new, is in extensive use and has a well established customer base.

However, what counts for investment is what potential infrastructure *investors* think about these matters. In our view, the Commission has failed to persuade the major investors in infrastructure that pricing practice will recognise the need for an acceptable financial return and that new irreversible investments will be not be expropriated at will at the first expedient opportunity.

In our view the Commerce Commission needs to be reminded that secure private property rights are critical to investment and that past investments do not, in themselves, constitute an undesirable barrier to entry, let alone proof of market power. It cannot be assumed that the investments induced by an mandated open-access regime are necessarily efficient. Nor is it credible to assume that the Commission could determine an acceptable return that was neither too high or too low. Any determination by the Commission will be merely a guess within a wide plausible range. But the most important deficiency in the Commission's analysis is its failure to understand that signals of a willingness to regulate as soon as an irreversible investment is committed are very negative for future investments of this kind.

The current inquiry provides stark evidence on this very point. In June 2005 the Commission recommended against the regulation of 3G because it was concerned that to do so might adversely affect investment. Its press release at the time noted that the planned investments were large and that it is important that the investors "have the opportunity to make them without facing the risks of returns being restricted by regulation". A mere six months later, in December 2005, the Commission reversed this recommendation on the basis that the observed rollout of 3G technology "suggests that the threat to investment in new technology is not as great as the Commission first thought".

The economic literature calls such behaviour "opportunistic". The regulator entices investors to invest on the basis that returns will not be regulated away, and then steps in after the investment is committed to expropriate some of the returns. In our view, any regulator who asserts that such unprincipled opportunism will not adversely affect future investment of this type is out of touch with commercial reality.

Nor is this an isolated case of abrupt changes in the regulatory environment that are not justified by any clear demonstration of a net gain to the community. The recently released Cabinet paper justifying the proposed regulations for local fixed lines reversed, without the benefit of any quantitative cost-benefit analysis, detailed and extensive earlier work by the Commission that found that such measures were not in the national interest. Other proposals to introduce mandatory roaming and to mandate cell site co-location raise similar concerns.

We are concerned that such initiatives indicate a marked policy shift towards intrusive regulation and arbitrary taking of shareholder wealth in this industry. The impression that is being created is that political interests, not the national interest, dominate such decisions. Politicised decision-making that ignores the cost to investors of transferring wealth to users or competitors has to be bad for the investment climate in such industries, given the volatility of political considerations.

In our view the Commission, and some officials, are far too removed from commercial realities to give competent advice on likely investor reactions to their current signals. Existing firms are not forced to invest in bringing new technologies into New Zealand just to keep customers happy. They have obligations to their shareholders. Shareholders do not have to invest in countries where they perceive a serious risk of opportunistic regulatory takings. Incumbents will undoubtedly continue to invest to some extent to preserve some value in existing assets, but they will tend to invest defensively rather than proactively. Given regulatory uncertainties, new entrants may feel that it is safer to 'free ride' on existing assets rather than to invest in new facilities and technology. Such developments would be at odds with the government's objectives for economic growth.

The compensation issue

When a government takes private land for a public use, such as a highway, there is no dispute that full compensation should be paid to the landowner. Not to do so would undermine individual freedoms, violate notions of fairness and harm economic development. Regulatory takings of property that reduce the value of legitimately held assets raise similar issues of compensation, at least in significant cases.

No argument has been made that investors in telecommunications have acted unlawfully or abused a dominant position. The payment of compensation to investors would reduce the disincentive to future investment in related infrastructure and new technologies, but the better approach would be adopt the discipline of preserving the sanctity of private property rights unless it can be clearly demonstrated that taking them is essential for the achievement of a necessary public interest, in which case the issue of compensation must be addressed. These tasks have not been attempted.

Conclusion

In our view the Commission's casual dismissal of concerns that its recommendations will adversely affect the rate of transmission to New Zealand of future mobile technologies is naïve and unwarranted. It is investors' views about these matters that count. We recommend that you decline the proposal to designate access on the grounds that no case has been made that it is in the public interest to do so, and that the likelihood of chilling effects on investment has not been given due weight.

Yours sincerely

R L Kerr
EXECUTIVE DIRECTOR