NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Commerce Commission's Draft Report on Telecommunications Act 2001 Schedule 3 Investigation into Regulation of Mobile Termination

November 2004

Summary

Introduction and overview

- This submission on the Commerce Commission's Draft Report on its Schedule 3 Investigation into Regulation of Mobile Termination under the Telecommunications Act 2001 (Draft Report) is made by the New Zealand Business Roundtable (NZBR), 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.
- The Draft Report provisionally recommends that the termination of voice calls on a non-third generation (3G) cellular mobile telephone network should be regulated on a cost basis. It does not recommend regulation of 3G mobile services. It remains open on whether mobile services are subject to limited competition. The Draft Report estimates that the proposed regulation might increase the sum of producer and consumer surplus over the five years to 2010 by $27 million (in present value terms). It asserts that this would be a gain in static efficiency.
- In this submission we show that this calculation is spurious. The estimate does not identify any indirect costs of price regulation, let alone attempt to quantify them. Instead its flawed methodology creates a bias in favour of regulation by essentially ruling out the possibility that indirect costs might exceed estimated benefits.
- The analysis of dynamic efficiency effects is also inadequate. Lacking an economic framework, its presentation of some possible investment effects as dynamic efficiency gains and others as losses seems to be arbitrary. It then claims without quantification that the effects that it has classified as gains are material, whereas the others are outweighed by static (consumer surplus) gains – as long as the proposed regulation does not encompass 3G.
- The literature on dynamic efficiency suggests that the Draft Report is wrong to focus on regulating prices down to cost for short-term static benefits. Such an

approach can be expected to seriously impair dynamic efficiency, which is much more important.[1]

- We regard the Commerce Commission's determination to interpret the Telecommunications Act as requiring it to weight distributional issues as a serious impediment to dynamic efficiency and to the integrity of competition policy generally. In our view, this is a major policy issue that needs to be resolved.
- We commend the Draft Report for judging that the costs of imposing price control regulation on 3G investments would likely exceed any benefits. However, in our view its belief that these costs will be reduced materially by its proposal not to regulate 3G immediately is unfounded. The general hostility of the Draft Report to investors in infrastructure (see section 4 of this submission for a long list of examples) virtually guarantees a general expectation on the part of investors that the Commission will regulate 3G at a later date.
- We submit that the Final Report should rule out price regulation on the grounds that the case for it is far too inconclusive and it is not possible now to regulate non-3G without creating serious doubts in investors' minds about the future regulation of 3G. We also submit that it needs to pay greater attention to the possibility that the Kiwi share could be distorting the market for mobile services and that it should comment on the case for abolishing or substantially modifying the Kiwi share obligation.

After some comments on the legal framework, the remaining sections of this summary follow the subject headings in the summary section of the Draft Report. Major themes include the importance of a principled approach to the assignment of the burden of proof and the deterrent effect for investors of the pervasive presumption in the Draft Report in favour of intrusive regulation.

Legal framework

- In our view the Draft Report has failed to address the issue of the burden of proof satisfactorily. The Commission should adopt a principled and transparent approach to determining what burden of proof it should require before

[1] Lewis Evans, Neil Quigley and Jie Zhang (2000), 'An Essay on the Concept of Dynamic Efficiency and its Implications for Assessments of the Benefits from Regulation and Price Control', New Zealand Institute for the Study of Competition and Regulation, http://www.iscr.org.nz

recommending regulation. It should not assume the licence to assign the burden of proof arbitrarily.

- We submit that the Commission should adopt the presumption that price controls will not be imposed unless the case for them overcomes a substantial burden of proof. We illustrate this approach with reference to Circular A-4 of the (US) Office of Management and Budget (OMB).
- We cannot understand the Draft Report's failure to acknowledge and evaluate reasonable efficiency interpretations of the Telecommunications Act (the Act). We submit that the Commission should interpret the Act as seeking to maximise economic efficiency, unless there is no doubt about its intentions to the contrary. We find that, contrary to the Commission’s interpretation, it is easy to interpret the sections of the Act that it cites as having an efficiency justification.
- We submit that the Commission is fostering that which the Act aims to avoid – detriments to the long-term benefit of end-users – when it adopts positions on wealth transfers and the burden of proof that are likely to deter irreversible investments in infrastructure. End-users cannot get a long-term benefit from investments that are deterred because of an investor-hostile approach to interpreting legislation.

Relevant markets and competition assessment

- We disagree with the Draft Report's arguments on market definition and competition. In our view they rest on inadequate economics and faulty assignments of the burden of proof.
- The economic arguments appear to underestimate supply and demand substitution effects for two reasons: (i) they overlook the importance for competition of the subset of users who are price sensitive and have choices; and (ii) they incorrectly assert that callers have "no choice" but to make a mobile call to contact a mobile subscriber.[2]
- On the burden of proof aspect, the Commission's "threshold test for intervention by way of regulation" – that "competitive forces do not operate fully"[3] – invokes a

[2] Draft Report, paragraph 140.
[3] Draft Report, paragraph 60.

textbook ideal that cannot be achieved in reality. It thereby favours a finding of limited competition. This creates a bias in favour of regulation.

- This bias is increased by the apparent willingness of the Draft Report to infer excess returns from a finding of limited competition, regardless of whether excess returns exist in reality, either *ex ante* or *ex post*.[4]

- The Draft Report's rejection of the 'waterbed' argument[5] also appears to reflect a pro-regulation bias. In the same paragraph the Commission finds that the evidence for retail mobile market competition is "mixed", yet it then goes on to interpret this as meaning that the argument that the retail market is competitive is unconvincing.[6] By the time the Draft Report gets to its cost benefit assessment, the waterbed argument has become non-existent.

- We submit that all these biases are detrimental to the Act's prime purpose – the achievement of long-term benefits for end users. The more the Commission signals that it is biased against infrastructure investors, the less investment in infrastructure there will be.

- In our view, the final report must address the distinctions between *ex ante* and *ex post* profits, clarify what levels of excess *ex post* returns the Commission will deem to be acceptable (in order to improve incentives to invest) and apply itself to analysing actual data on costs and returns.

Cost benefit analysis

- It is unacceptable to propose a regulation without establishing that it benefits overall New Zealand interests. This is provided for in Regulatory Impact Statements around the world, in the OMB's Circular A-4 and in the Commerce Commission's own guidelines for evaluating dominance, mergers and acquisitions. Yet the Draft Report makes no attempt to argue that there is a net overall (efficiency) benefit from its proposed designation.

- Its assessment of costs does not appear to establish how costs vary with output, or how joint or common costs are to be recovered. Nor does it address the issue

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4 Draft Report, paragraph 11.

5 The waterbed argument is that common and joint costs must be recovered somehow so that if a regulator forces down one charge a rational profit maximiser will make compensating adjustments to charges to other products (or reduce quality) – whether markets are competitive or not.

6 Draft Report, paragraph 340.

of whether excess returns on past investments actually exist. The methodology is predatory with respect to past investments.

- The Draft Report treats a (convoluted) estimate of the uncertainty in calculating benefits as an estimate of indirect costs. It is nothing of the sort. Indirect costs arise from the unintended and undesired effects of regulation. The failure of the Draft Report to identify and consider explicitly the likely costs of regulation contrasts sharply with its presumption that markets fail if outcomes deviate from an ideal state.
- In the absence of any estimate of indirect costs, the only valid finding is that the Commission does not know whether the static net benefits are positive or negative.

Dynamic efficiency

- The Draft Report lacks an economic framework for distinguishing dynamic efficiency gains from dynamic efficiency losses.
- Its drive to force cost-based pricing for static efficiency reasons suggests that it does not appreciate that this may well be inconsistent with achieving the more important goal of dynamic efficiency.
- We commend the Draft Report for being seriously concerned about the cost of discouraging investment in 3G, but suggest that it fails to appreciate the importance of providing credible signals to investors in 3G that they will be permitted to retain excess profits from those investments if they are successful (in order to offset the risk of failure). As noted in section 4, the cumulative effect of the Draft Report's arguments and presumptions is hostile towards investors in infrastructure.
- Since we cannot see how the Commission could now make a credible commitment to 3G investors in the light of its Draft Report, we think that the only recommendation the Commission can make in the long-term interests of end users is to reject regulation at this point.

SUBMISSION ON THE COMMERCE COMMMISSION'S DRAFT REPORT ON TELECOMMUNICATIONS ACT 2001 SCHEDULE 3 INVESTIGATION INTO REGULATION OF MOBILE TERMINATION

1.0 Introduction

1.1 This submission on the Commerce Commission's Draft Report on its Schedule 3 Investigation into Regulation of Mobile Termination under the Telecommunications Act 2001 (Draft Report) is made by the New Zealand Business Roundtable (NZBR), 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. We believe that all our members are users of mobile telecommunication services; some are in competition with each other as suppliers. We take the view that public policy should not be focused on benefiting either consumers or suppliers and instead should aim to maximise the overall gain to both groups. This objective is commonly expressed as maximising the sum of producer and consumer surplus.

1.2 The Draft Report results from a decision by the Commission in April 2004 that there were reasonable grounds for an investigation into mobile termination rates under clause 1(a) of Schedule 3 to the Telecommunications Act 2001 (the Act). In announcing its decision to investigate, the Commission identified the following relevant factors: (i) cost-based estimates of termination rates in other jurisdictions were higher than current charges in New Zealand; (ii) Telecom and Vodafone appear to have substantial market power in New Zealand, and overseas regulators have identified competition issues in their markets and argued that the arrangement that the calling party pays for the costs of termination is a source of market power; and (iii) spending on mobile phones is sufficiently large to justify an investigation.

1.3 The Commission published an Issues Paper on 21 June 2004, and invited public submissions on the matters raised. The NZBR made a brief submission on 31 August 2004. It expressed concern about the investigation given the dynamic nature of this technology and the Commission's dubious reasoning. It argued that dynamic efficiency concerns justified imposing a material burden of proof on proposals to regulate mobile services. We also urged the Commission to acknowledge in its communications to investors in infrastructure the need to preserve their ability to achieve supernormal *ex post* returns in order to balance the risk of achieving inadequate *ex post* returns. Our analysis of the Draft Report has heightened all our concerns.

1.4 The Draft Report recommends that the termination of voice calls on a non-3G cellular mobile network be regulated on the grounds of limited competition and evidence of pricing above cost. It acknowledged the likelihood of problems in distinguishing between 3G and non-3G services (see paragraph 567), but was concerned about the risk of major dynamic efficiency losses from attempting to regulate networks that are still only in the planning stages (see paragraph 562). The Draft Report estimates (see paragraph 522) that the proposed regulation might increase the sum of producer and consumer surplus over the five years to 2010 by $27 million (in present value terms). It estimates (see paragraph 510) that the static net consumer benefit would be of order of $185 to $217 million over the same period in net present value terms and judges (in paragraph 565) that this gain to consumers would exceed any efficiency losses.

1.5 The Commission seeks comments on its Draft Report and has posed six questions for submitters, while not wishing to limit responses to these matters.

1.6 Section 2 of this submission comments on the assumptions and arguments in the Draft Report that are important for the static cost benefit calculations. Section 3 comments on the discussion in the Draft Report relating to dynamic efficiency. Section 4 makes some concluding remarks.

2.0 The cost benefit assessment

2.1 The Draft Report's cost benefit assessment presumed that end-user prices from fixed lines to mobile phones could be reduced (by regulation of termination charges) from around 42 cents a minute currently to 22 to 27 cents a minute (in round numbers) by 2010. In the absence of regulation, it projected a smaller fall to 33 cents a minute (rounded) by 2010. Given the assessed cost of supply of 22 cents a minute[7] (rounded), all the price reductions from regulation would contribute to static efficiency gains because expanded demand would increase the sum of producer and consumer surplus.

2.2 In the Draft Report the Commission is commendably methodical in taking the reader through the key steps in its cost benefit calculations. It largely acknowledges and responds to contending points of view along the way, and sets out its reasons for the positions it takes on each contentious issue. Contentious steps and conclusions in its analysis include its:

- dismissal (paragraph 53) of Telecom's argument that the Commission should require for itself a high level of comfort before recommending regulation;

- rejection (paragraph 67) of Vodafone's argument that section 18 of the Act (the ‘Purposes’ section) should be read as giving more weight to efficiency issues than to distributive issues. Instead the Commission takes the view that the weight to be put on distributive issues under the Act is "a matter of judgement";

- "market definition" findings (paragraphs 140 and 141) that (i) there is a "termination bottleneck", (ii) 'calling party pays' billing implies low demand substitutability between different networks, and (iii) there is limited supply-side substitution for mobile termination;

[7] The largest component of this estimated 22 cent cost was the 16 cent component attributed to termination. At paragraph 181 the Draft Report states that the current charge to terminate a call is around 28 cents a minute. It is this estimated 12 cent (28-16) gap that lies at the heart of the Commission's concerns.

- assertion that 16 cents per minute is likely to be a "robust and reasonable" estimate of the costs of terminating calls on mobile networks in New Zealand (paragraph 401);
- assertion that forced reductions in termination charges would not induce higher charges elsewhere in the telecommunications system;
- decision to adopt a five-year time horizon for analysis (paragraph 348) for assessing long-term benefits for end users; and
- calculation of the static indirect costs of regulation as an arbitrary 25 percent of any excess return from pre-control prices and 43.75 percent of any deadweight gain in consumer surplus (paragraph 497).

2.3 We comment on each of these opinions below.

The burden of proof/degree of comfort issue

2.4 The Draft Report argues that the Act does not prescribe a "high standard of comfort". It argues that the Act instead "requires the Commission to make a recommendation that best gives, or is likely to best give, effect to the purposes set out in section 18". We agree that the Act does not prescribe the burden of proof the Commission should set for itself, but submit that this does not dispose of the matter. In the interests of sound administrative practice and investor certainty, the Commission should make it clear that it will not interpret such an omission as a licence to set the burden of proof arbitrarily or inconsistently. Rather, it should address the issue in a principled and transparent manner.

2.5 There is no need for the Commission to regard this as a difficult task. It could start, for example, by affirming that it will adopt the following presumption promulgated by the US Office of Management and

Budget Guidelines for evaluating regulations. This is known as Circular A-4, issued on 17 September 2003:

> The Presumption Against Economic Regulation
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> Government actions can be unintentionally harmful, and even useful regulations can impede market efficiency. For this reason, there is a presumption against certain types of regulatory action. In light of both economic theory and actual experience, a particularly demanding burden of proof is required to demonstrate the need for any of the following types of regulations:
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> • price controls in competitive markets …

2.6 Intrusive regulation of private markets generally does more harm than good. While in the case of monopoly regulation has a greater potential to do more good than harm, the history of antitrust actions is troublesome because of problems of changing, often simplistic, economic theories, inadequate information, flawed incentives and regulatory and judicial delays. A recent review of the efficacy of antitrust policy in the United States by two Brookings Institution researchers found that there is:

> … little empirical evidence that past interventions have provided much direct benefit to consumers or significantly deterred anticompetitive behaviour.[8]

2.7 A presumption against intrusive state regulation of competitive markets places the burden of proof on any proposal that a market is sufficiently uncompetitive to justify intrusive regulation. In our view, the burden of proof should be particularly high in an area like mobile telephony where competition between infrastructure suppliers is manifestly intense.

Wealth Transfers

2.8 Mobile telephony is a dynamic technology. Major advances can require large, risky, irreversible investments in licences and infrastructure. It is hard to think of a greater deterrent to such

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8 Robert W Crandall and Clifford Winton, 'Does Antitrust Policy Improve Consumer Welfare? Assessing the Evidence', *Journal of Economic Perspectives*, Fall 2003, pp 3-26. (For a defence of antitrust laws by a former director of the Federal Trade Commission, see the next article by Jonathan Baker in the same issue. In footnote 10 Crandall and Winton argue that Baker's arguments substantially underestimate the competitiveness of US industry generally and fail to acknowledge in a balanced way that antitrust actions can deter socially beneficial activity as well as socially harmful activity.)

investments than the threat that the state will expropriate the returns from those investments by (arbitrarily) weighting end-user interests ahead of investor interests.

2.9 The Draft Report sets out on page 11 the Commission's case for explicitly considering wealth transfers:

> It is precisely because there is a concern about monopoly profits, and a lack of competition to drive them out that control might be justified. In such an environment, the Commission considers that the scheme and context of the Act means that it must explicitly address distributive issues …
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> The Commission considers that once it is recognised that the [Telecommunications] Act [in Schedule 1] promotes cost-based access pricing, the inevitable consequence is a transfer of producer surplus. This transfer then becomes an inevitable consequence, and benefit, of regulation. In addition, the underlying rationale is that this is the likely outcome in a competitive market.

2.10 We cannot understand why the Commission fails to consider the alternative possibility that the purpose of the Act is to address orthodox economic concerns with private monopoly. In orthodox economics, the concern with monopoly profits relates to efficiency, not distribution. At Econ 101 level, pricing above marginal cost is a concern because it does not exhaust all conceivable gains from trade. The potential efficiency benefits from these unrequited gains are illustrated by the familiar diagrammatic 'deadweight cost' loss triangle. However, the same theory accepts that pricing above marginal cost is efficient if it is necessary in order to cover average costs – as in the natural monopoly (declining cost) case, or in cases of joint supply or common costs. It follows that if the legislation is concerned with efficiency, it would allow private suppliers to recover average cost, and would only steer the Commission to consider action if price exceeded both marginal and average cost. Prices in excess of average cost (ie excess profits) would be efficient if marginal cost exceeded average cost. It follows from this economic theory that the existence of excess profits (*ex ante*) is a necessary but not sufficient condition for regulation to be considered in order to improve economic efficiency. By not addressing this interpretation of the Act the Draft Report fails to provide any basis for rejecting it.

2.11 The Draft Report's discussion (paragraph 61) of the Baumol Willig rule in Schedule 1 of the Act similarly fails to provide any basis for rejecting an economic interpretation of these sections. Under the assumptions of Baumol and Willig's model, the Baumol Willig rule is a necessary condition for a 'perfectly' efficient equilibrium outcome.[9] It is not a sufficient condition because the rule provides for an efficient *interconnection* price, but not for an efficient *final* price to end users. The manifestation of an inefficient final price to end users (compared to a perfect world) is excess profits from final prices that exceed marginal cost and allow average revenue to exceed average cost. Baumol and Willig suggested that addressing this excess profit *efficiency* problem might require a second instrument – possibly the regulation of end-user prices. The desirability of such regulation would depend on a cost benefit assessment – based on efficiency considerations, *not* distributional considerations. In our view that is exactly the approach the Commission should be taking in its cost benefit analyses. Many non-experts widely interpreted the furore over the Baumol Willig rule as a debate over distribution (excess profits), and it does not help public understanding for the Commission to add to this confusion.

2.12 With respect to legislative references to monopoly profits, we suggest that the Commerce Commission should interpret, if at all possible, any references to excess profits as acknowledging that pricing above (*ex ante*) average cost is not desirable on static efficiency grounds when average cost exceeds marginal cost. (Pricing above *ex ante* average cost may be desirable when marginal cost (or consumers' opportunity cost) exceeds average cost, or on dynamic efficiency grounds.[10]) We suggest that the Commission should also make it clear that pricing above *ex post* average cost is also acceptable where the excess is a result of luck or skill rather than the abuse of a monopoly position.

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9 For a recent discussion of this rule using more sophisticated modelling, see Ingo Vogelsang, 'Price Regulation of Access to Telecommunications Networks', *Journal of Economic Literature*, September 2003, pp 830-862, particularly p 835.

10 Vogelsang, *op cit* p 835, shows that it is possible that pricing according to a more sophisticated version of the efficient component pricing rule might be *below* the welfare-maximising price.

2.13 In short, if the Act has any economic rationale, the gain from eliminating monopoly profits is an efficiency gain (the reduction or elimination of the deadweight cost). Contrary to the Commission's conclusion above, any wealth redistribution that results from this efficiency gain is not material to the analysis. Such a redistribution is not desired in itself and it is illogical for the Commission to assume that it is.

2.14 The Commission's failure to consider an efficiency interpretation of the Act is all the more puzzling in the light of its past clarity on this issue in respect of mergers and acquisitions. The (latest) December 1997 version of its Guidelines for the analysis of public benefits and detriments arising from the lessening of competition or from acquisition of market dominance states plainly that:

> …[p]ublic benefits must be net gains in economic and/or social terms "efficiency gains). Transfers of wealth *per se* are not net gains.[11]

2.15 The Commission reasserted this position in its submission to the High Court this year on the Air New Zealand/Qantas case. It stated that the argument [that a wealth transfer from New Zealand consumers to producers was a detriment]:

> … is inconsistent with the language of the Act, the Commissions' long-established practice in respect of transfers, and the caselaw on this in New Zealand. It puts unsustainable weight on the change to the purpose provision in 2001, and would lead to undesirable policy outcomes. These issues are discussed in detail in section 43 below.[12]

In paragraph 241 of its judgment the high Court accepted that such wealth transfers should be treated as neutral.

2.16 In its consideration of the issue in the context of local loop unbundling, the Commission attempted to establish a distinction between merger cases and 'regulated industries' on the basis that authorised mergers are subject to competitive forces. This defence is contradicted by the provision that mergers can be authorised if detriments from reduced competition are outweighed by efficiency

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11 We note that as at 9 November 2004, the Commission's website states that these guidelines are being revised in line with new legislation and "are no longer the Commission's view".

12 Submissions of Counsel for the Commerce Commission 29 June 2004, public version, paragraph 2.49. Section 43 runs from pp 158 to 169, reflecting the extent of the Commission's comprehensive rebuttal of this proposition.

gains. Nor does it overcome the Commission's objections (above) to allowing such wealth transfers to be considered in merger situations. Competition legislation in New Zealand is incoherent if it authorises efficient outcomes in mergers but not in regulated industries. Investment in regulated industries must be inhibited if transfers of revenue to consumers are counted as a national interest benefit.

2.17 As further support for the point we are making, we draw the Commission's attention to the Office of Management and Budget's Guidelines on the development of regulatory analysis (Circular A-4) are unequivocal on this issue. They state:

> You should not include transfers in the estimates of the benefits and costs of a regulation. Instead, address them in a separate discussion of the regulation's distributional effects.

They also state that:

> You should include these effects in your analysis and provide estimates of their monetary values when they are significant:
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> Private-sector compliance costs and savings;
>
> - Government administrative costs and savings;
> - *Gains or losses in consumers' or producers' surpluses* (emphasis added);
> - Discomfort or inconvenience costs and benefits; and
> - Gains or losses of time in work, leisure and/or commuting/travel settings.

2.18 Finally, from an academic source, we note that Thomas Jorde and David Teece (eds) *Antitrust, Innovation and Competitiveness* (New York: Oxford University Press, 1992, p4) state:

> Professional economists are in almost universal agreement that economic welfare ought to be the only goal of antitrust policy.

2.19 We submit that the Commission should presume that its governing legislation is promoting efficiency, except when unequivocal words in the Act (or subsequent Court decisions) dictate otherwise. No credible case has ever been made that antitrust actions are a socially beneficial way of transferring wealth between groups in society given a government's ability to use tax and welfare policies for such an objective. After all, not all investors are rich and the distinction between investors and consumers is artificial in that all wealth ultimately belongs to people who are consumers. It is time that the Commission acknowledged these efficiency interpretations of its legislation and addressed the issue of where it stands on the need for consistency with the Commerce Act and related legislation. We suggest that it is not in the longer-term interests of investors, end users or ultimately the Commission itself for it to claim arbitrary powers when this could be avoided by a more sensible and economically coherent interpretation of its governing legislation.

2.20 If, nonetheless, the Commission persists with its current approach, we submit that it is very important for investment decisions (dynamic efficiency) that it does not allow itself to claim the power to make arbitrary decisions about the weight to be put on distributional issues where it has some choice on the matter. The Commission's "matter of judgement" response in paragraph 67 provides no principles whatsoever for limiting its discretion. We draw the Commission’s attention here to the submission of the Counsel of the Commerce Commission to the High Court in the Air New Zealand/Qantas merger case on this issue. This submission found in paragraphs 43.36 to 43.40 that Canadian jurisprudence, in the *Superior Propane* decisions, supported a case for higher weights on gains to the “poor and needy”. However, the implied change in weights (from the ‘equal value’ 50:50 weights under the total surplus approach) was very small, only affecting weights calculated to the “second decimal point”. The general effect, in terms of outcomes, was that such an adjustment would make “no significant difference” to the Commission’s existing approach in New Zealand. If the Commission is determined to apply distributional weights it should establish and publicly articulate a rigorous methodology along the lines developed by the Canadian Competition Tribunal so that the private sector is clear about how the Commission will reach its decisions.

Market definition

2.21 The Commission's reasons for finding that the appropriate product market for market definition purposes is the market for termination services are summarised in five bullet points in paragraph 140. In respect of the first argument, we do not see that it is meaningful to say that there is a 'termination bottleneck' simply because a party calling someone's mobile phone must connect to that mobile network (paragraph 140). That terminology seems to confuse an exclusive private property right with a monopoly problem. The term 'bottleneck' suggests a constriction on traffic. However, a system of relatively unfettered private property rights actually facilitates the flow of traffic by allowing adequate capacity to be funded (compared to the 'tragedy of the commons' situations that can be expected to arise where intrusive regulation deters investment in infrastructure).

2.22 Furthermore, the claim that the originating customer lacks alternative means of contacting a mobile subscriber is simply untrue in many, if not nearly all, situations. Many people sit at their desks with a computer, fixed line and a cell phone. If they want to contact someone else, all three could well be an option. If time is not of the essence, as is usually the case, they could use any of these alternatives, and leave a message on the other party's computer, home or office landlines, or mobile. Or they could leave a message with a colleague, friend or family member. Any notion that they must take the landline-to-mobile option is false.

2.23 The second argument, that 'calling party pays' unduly reduces the attention people pay to their choice of address, is similarly unconvincing. People take into account the convenience of ready access between themselves and friendly parties when they decide where to live. There is no reason to think it would be different in their choice of network provider.

2.24 The third proposition, that there is "little evidence to suggest that subscribers may care more about the cost of incoming calls than about the cost of the calls they make", seems to be an irrelevant, straw argument. First, the Draft Report does not identify any argument to the contrary. Second, it articulates no theoretical reason why it matters for market definition whether subscribers (in general) care more, less, or just as much. In the absence of an articulated rationale, we surmise that the implicit theory is that unless there is universal full information and awareness, markets fail to reach some ideal standard.

2.25 Evidence from polls that many or most users are unaware of costs being paid by calling parties is not proof of market power or an information problem. It may simply reflect rational ignorance by users who do not regard the costs in question as being high enough to warrant greater attention. This indifference could reflect some combination of a (low) level of usage or a low unit price rather than a lack of regard for the costs to callers.

2.26 If the Commission desires to articulate a preferred theory of information, we suggest that it should accept that it is competition at the margin that drives investment and prices. There is no requirement in the real world that all customers are knowledgeable or shop around. The great majority of customers in any homogenous market do not have to shop around. As long as a sufficient number of price-sensitive shoppers are shopping around, the price they pay sets the price for others. We submit that the final report should correct all the analytical errors of this type (for an example of this error in another context, see paragraph 166).

2.27 A critical issue here is the Commission's threshold or burden of proof for finding that substitutes are so limited as to justify calling something a separate market. The Draft Report appears to come closest to identifying its threshold in paragraph 83. It determines that substitutability is "limited" on the basis that substitution is imperfect on at least some occasions. Again this appears to be an idealised standard that virtually guarantees a real world 'conviction'. By the same logic, butter and margarine are not identical products, so substitutability must be 'limited'. Again the Commission's determination to apply a burden of proof on actual competition that cannot be surmounted can be expected to deter investment.

2.28 The fourth argument, that fixed termination rates are already regulated so reciprocity does not apply, is obscure since it is not articulated elsewhere in the report. It seems to condone 'regulatory creep' – the notion that constraints on competitive processes caused by one regulation might justify another.

2.29 The fifth argument, that evidence from overseas does not suggest that competition for subscribers constrains termination charges, again begs the question of where the Commission is placing the burden of proof. The discussion drawn from overseas jurisdictions appears to be tenuous in several dimensions: (i) it does not identify the relevant counterfactual or consider differences in the regulatory and competitive environment in overseas jurisdictions from the situation in New Zealand; (ii) it seems to rely on data that are too limited to be capable of confidently ascertaining a change in trend; and (iii) it seems to embrace the fallacy that competition at the margin can be inferred from average customer statistics. Once again, where there is doubt, the Commission appears to place the burden of proof on the arguments against regulation.

2.30 In paragraph 141 the Draft Report makes the unequivocal assertion that "calling party pays billing significantly weakens any switching constraint faced by mobile operators". We could find no supporting empirical evidence for this assertion in the Draft Report. Nor does the Draft Report cite any independent authority in support of it. The claim seems to rest on the authority of similar assertions by some regulators in other countries, notably the European Union and Australia. However, regulators are not disinterested parties who are paid for their expertise in independent economic analysis. They are often players in a regulatory 'game' and have a common interest in supporting arguments likely to increase their power, influence or budgets. This reduces their willingness to contest arguments that would be counter to their interests. We suggest that the Commission will do end users a disservice if it relies on the claims made by overseas regulators. The final report should either drop this strong assertion or explain directly its empirical and theoretical basis.

2.31 We conclude that the Draft Report's conclusions on market definition are unconvincing. They appear to underestimate supply and demand substitution effects for two reasons: (i) they overlook the importance for competition of the subset of users who are price sensitive and have choices; and (ii) they assert that the marginal caller must always, or even usually, make a mobile call.

'Robust' cost estimates

2.32 It is hubris to describe an estimate of forward-looking costs for mobile telephony as 'robust'. Economic costs are opportunity costs and these are subjective. A market in mobile telephony (and wireless) can be seen as a contest between entrepreneurial suppliers with different views about how future technologies, costs and consumer preferences will evolve. Their perceptions of market, business and regulatory risks will differ. Even the risk preferences and skills of their investors may differ as between, for example, venture capitalists and institutional investors. Their assessments of likely rates of economic depreciation will differ and their cost of capital may differ.

2.33 It may be possible to get a 'robust' estimate of the replacement construction cost of a telecommunications network, but for all the above reasons it is not possible to derive from that a robust estimate of the annualised cost of that network given tax, regulatory, technology, market and business risks.

2.34 The Commission is confronted with a graphic illustration of the problem of subjective costs each time firms making submissions give it wildly differing estimates of the returns (eg from 13 percent per annum to 4 or 5 percent per annum) that they assert the investors in their respective firms would require in order to supply a given service. Taking such differences at face value, one firm (usually the one wanting the Commission to regulate prices down) might effectively assert that its investors have half the cost of capital that the incumbent firm reports its investors would require from the same investment. This implies that the disagreement concerning the annual capital cost of supply of supplying a network is around 100 percent. What then is a 'robust' estimate of the 'true' cost? The answer is that there is no robust estimate because there is no 'true' cost; there is only a contest between differing views of risk and return. Usually investors would sort this kind of dispute out in the takeover market. Other things being equal, the investors with the lowest cost of capital for the given venture would value it the most highly, and buy the other investors out.

2.35 The notion of a 'robust' cost estimate is even more inconceivable in a joint cost situation. Many services are provided by landlines jointly. Markets allocate joint costs through a process of supply and demand. Mark-ups may be greatest where consumer demand is greatest, as is illustrated by the differences in price per kg between rump steak and minced beef.

The 'waterbed' issue

2.36 If the supply of the joint products is competitive, in time competition will drive any initial (*ex ante*) excess returns out of the market. However, it may not force the price of any particular product to track incremental costs closely. If a regulator constrains the mark-up on one product, compensating offsetting adjustments must occur through supply and demand to the mark-ups on other products, reducing the consumer surplus on these products. Otherwise firms will be forced to exit. The regulatory action will have reduced overall welfare.

2.37 Alternatively, if the supply of the joint products is uncompetitive, each supplier will be providing the quantity of the bundled product that equates marginal revenue and marginal cost. If the regulator forces the price of one component product down, the effect will be to reduce marginal revenue at the original level of output, without reducing marginal cost. The profit-maximising monopolist must now reduce the bundled output in order to equate new marginal revenue to marginal cost. The reduced output for the unregulated products implies a higher price and reduced consumer surplus from those products. In this case it is not clear whether the regulatory action will have raised or lowered either overall welfare or consumer surplus.

2.38 In either of the above situations, the Commission's rejection of the 'waterbed' problem of offsetting effects appears to be inconsistent with rational profit-maximising behaviour. If so, it is incoherent as an explanation of market behaviour.

2.39 In terms of the evidence it can muster on this issue, the Commission finds (in paragraph 340) that the evidence on retail mobile market competition is "mixed". It immediately assigns the burden of proof on this question in favour of regulation by concluding that "mixed" evidence means that the argument is unconvincing. In paragraph 342 it makes the strong assertion that increases in other charges are "not likely" and if they do occur there is "no reason" to expect them to "exceed" (or match?) the offsetting forced reduction in termination rates. In its cost benefit calculations it assumes that there are no offsetting increases at all. This biases the Draft Report even further in favour of recommending regulation.

2.40 We conclude that the Commission's analysis of this problem needs to be formalised in order to establish what it is assuming about rational profit-maximising behaviour. We suspect that if it undertakes this exercise, the Commission will find that it needs to model the responses in the mobile product markets in order to make an overall cost benefit assessment relating to welfare or consumer surplus.

Are there any public benefits from the proposed regulation?

2.41 The Draft Report assumes that there are public benefits from forcing prices down. Its cost benefit calculations assume that costs are flat throughout the supply range and are at or below the regulated charge. This constant returns to scale assumption jars with the Draft Report's earlier finding that there is an entry barrier (monopoly) problem. It also assumes away the problem of having to establish that existing suppliers are actually achieving excess profits.

2.42 The Draft Report effectively asserts in its executive summary, paragraph 11, that excess profits are being earned when it states that it "is not persuaded" that they "are being dispersed through competition for retail mobile calling and subscription services". It thereby assumes what needs to be proven. An electronic search of the document reveals only two other specific references to excess profit or monopoly profit. One is in paragraphs 60 and 62 where the Commission states *inter alia* that its threshold test for recommending intervention is that competition is limited, being less than "full" so that it is unlikely that competitive forces will "ensure appropriate treatment of any monopoly profits".[13] In addition there are three separate references to excess returns. On page 35, the Commission states that it will consider evidence that the access provider is "acting inefficiently or achieving excess returns". On page 57 (paragraph 311) it states that the potential benefits of regulation arise from reducing inefficiency "and/or excess returns". On page 94 (paragraph 511) it states that some of the benefits in the cost benefit analysis arise from a transfer of "excess returns" to consumers.[14] In short it does not examine actual returns at all.

2.43 It would be difficult to envisage an approach to these issues that paid less regard to clarifying conceptual and measurement issues or to determining whether monopoly profits were being earned in reality. On the former, we ask the Commission in its final report to clarify its references to costs by explaining if it is referring to current *ex ante* costs, past *ex ante* costs or accounting *ex post* costs. It should similarly clarify its references to monopoly profits. Excess returns *ex post* may simply reflect skill or luck rather than the results of *ex ante* monopoly profits. The stage 1 textbook concern with monopoly in economics relates to excess *ex ante* returns from pricing above *ex ante* marginal and average cost at the time the original investment was made (these are derived from expected revenues and past *ex ante* costs). Excess *ex post* returns are not proof of monopoly. To illustrate the need for clarification, paragraph 60 refers to monopoly profits and excess returns, but does not clarify what it means in terms

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[13] The third reference is at paragraph 329 where TelstraClear refers to excess profits.

[14] Under the assumptions of the Commission's model all producer surplus is an excess return since all costs are flat. Again, this assumes what should be proven.

of the above distinctions. Similarly, paragraph 311 refers to excess returns, but fails to make the *ex ante* or *ex post* distinction.

2.44 The Commission adopted long-run incremental cost (LRIC) as the measure of the cost of supply of termination services in its cost benefit assessment (paragraph 503). It estimated LRIC at 22 cpm using "benchmarking against cost-based rates in overseas jurisdictions, regulatory cost models overseas, and information provided to the Commission" (paragraph 203).

2.45 The Draft Report does not explain how the cost models deal with the joint cost problem or the recovery of common costs. It does not discuss how regulatory costs and risks, or tax, are factored in. It acknowledges the need for "Ramsey" pricing in order to recover common costs, but rules out its use "given the lack of reliable data and absence of competition" (paragraph 74). (This further illustrates the hubris in the claim that its cost estimates are 'robust'.) Once again the Draft Report adopts an anti-investor burden of proof to reach a decision. The Commission's apparent indifference here to the need to recover common costs is a further negative signal for investors. The Commission should clarify its position on this matter.

2.46 We submit that the Commission needs to address itself to two further matters in considering its final report. One concerns its basis for assuming constant returns to scale. Its discussion seems to indicate that the figure of 22 cpm is a point estimate. It is impossible to determine whether marginal or incremental cost is rising, falling or constant when there is only one observation. The Draft Report seems merely to assume it is constant. The second matter is regulating charges arising from past investments on the basis of current *ex ante* costs. The Commission will deter future investment if it signals that it will force down charges for recovery of past investments whenever *ex ante* costs fall but will not give any compensation for losses on past investments.

2.47 The Commission should also make it clear to investors that it accepts that supernormal *ex post* profits, like *ex post* losses, are expected outcomes from healthy competitive processes and will not be confused with monopoly profits. Otherwise, it invites future investors in facilities competition to infer the worst.

The time horizon issue

2.48 Five years is far too short a period for assessing the indirect costs of regulation or the long-term benefits to end users. Price control is likely to produce short-term gains for consumers with offsetting losses further out as the distortions caused by such controls mount and production costs rise. Perhaps this is why the Commission makes no attempt to assess such costs directly. We have argued in the past that the time horizon for analysis should be at least as long as the duration of the investment. Markets have to look this far ahead when evaluating an investment. Regulators should not adopt a different timeframe. The Commission's plea that there is a standard time period for regulatory investigations may simply reflect the inability of anyone to design a regulatory scheme that adequately focuses regulators' attentions on the long term.

2.49 A five-year time horizon fails to take into account investors' legitimate expectations that returns over the economic life of an investment will match or exceed costs. Infrastructure investors normally expect to incur initial losses that are covered by later profits. To look at a period in which profits are being achieved and to ignore other periods is simply to tell investors that the regulatory regime is hostile to investment. Once again we urge the Commission to communicate with investors on the time horizon issue in a way that assures them that they will not be deprived of opportunities to earn *ex post* excess returns for substantial periods should an investment be successful.

The estimation of static indirect costs

2.50 The indirect costs from antitrust regulation arise from undesirable behavioural responses. Intrusive regulation suffers from the problems of limited information, flawed incentives, and the likely abuse of the power of the state in favour of politicians, regulators, or interests that can capture the regulator. Regulators may abuse their discretionary powers in order to increase their power, influence or budgets. For example, a regulator may threaten a firm with the costs of major investigation unless the firm complies with some demand that it might otherwise have contested in a court. On the other hand, movements of personnel between the regulator and the industry may facilitate capture. Intrusive regulation makes the regulator part of the competitive process, particularly when competitors are vying to use regulation to secure a commercial advantage. Delays to the introduction of new products and services caused by regulatory and judicial processes can also cause material and irrecoverable losses. Regulations may fail to keep up with rapid changes in the marketplace. Regulation also stimulates lobbying and rent-seeking activities that use real resources in socially unproductive ways. Conceivably, the cost of rent seeking could exhaust any gains in economic rent. Desirable competitive behaviour may be deterred because of failures of economic theorists to identify whether a particular form of behaviour is competitive or anti-competitive. Desirable investments may be deterred (eg in facilities competition) because of fears that the benefits will be expropriated. At the same time, undesirable and ultimately unsustainable parasitic investments may be induced. Competitors may be able to use antitrust regulation to raise a rival's costs. If controlled prices are set too high, too much entry may occur. If they are set too low, desirable entry will be deterred, quality could be reduced and undesirable cross-subsidisation may occur. According to some research the welfare losses from delays and price distortions are likely to be quite large.[15] Crandall and Winston suggest that the indirect costs of antitrust regulation in the United States are much larger than the direct costs.

2.51 The Draft Report largely ignores all these difficulties with regulation and makes no attempt to estimate any of these indirect costs. Instead it erroneously adjusts estimated benefits – on the basis that they might have been overestimated because the industries' 'true'

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15 Evans *et al*, *op cit*, p 22.

costs of supply might have been underestimated[16]– and misleadingly calls the adjustment factor an estimate of indirect costs. It is nothing of the kind. It represents a revised estimate of benefits that is independent of the magnitude of any direct and indirect costs. The error is pernicious because it creates a bias in favour of regulation by denying the possibility that the indirect costs can come within 75 percent of the benefits.

2.52 This error plays a critical role in the Draft Report's assessment of static costs and benefits. For example, estimated indirect costs in the "Factual 1 scenario" plummet from a net present value of $80.84 million in table 17 (page 93) to $5.68 million in table 20. The change is purely mechanistic and bears absolutely no relation to the true indirect costs which are unchanged between the two tables. The difference simply reflects the mechanistic estimation of indirect costs by applying an arbitrary 25 percent proportion to the gain in consumer surplus in the first table and to a much smaller measure of producer surplus in the second table. This difference is critical to the overall public benefit conclusion because the overall change in the sum of producer and consumer surplus has a present value of $43.71 million. Indirect costs of $80.84 million would make the overall net benefit negative.[17] Instead the dramatically reduced estimated indirect costs allow the Commission to claim positive net public benefits of around $27 million (paragraph 522). These findings are clearly spurious given the artificial methodology.

2.53 The correct approach to uncertainty would be to assess a sensitivity range for estimated benefits and estimate indirect costs directly, again with an uncertainty range.

2.54 In conclusion, the Draft Report's findings of positive net public gains in static efficiency are spurious. In reality it has not even attempted to identify the nature of indirect costs, let alone assess their magnitude.

16 This rationale is inconsistent with the earlier assertion that the Draft Report's estimate was reasonable and robust.

17 The same is also true for Factual 2, as can be seen by comparing tables 18 and 21.

The Commission should conclude that it lacks the information necessary to reach a conclusion on this issue.

3.0 The assessment of dynamic efficiency

3.1 While the effects of intrusive regulation on dynamic efficiency are harder to assess than the effects on static efficiency, "a plausible argument can be made that the dynamic welfare losses from regulation greatly exceed their static counterpart". A particular risk with price regulation is that "it reduces the incentive to innovate because it limits the returns to innovating".[18]

3.2 The Draft Report freely acknowledges that price regulation is a threat to dynamic efficiency. At paragraph 562 it assesses that the dynamic efficiency losses from the chilling effect of regulation of 3G technology would likely outweigh any other efficiency gains, even when consumer surplus is the only measure of welfare. It therefore proposes not to impose price control on 3G at this stage.

3.3 However, the Draft Report does propose to regulate 2G technologies. In reaching this conclusion it considers in paragraph 564 two remaining possible dynamic efficiency detriments (delayed or reduced investment by Telecom or Vodafone in non-3G, and deterred investment in non-3G due to the "regulatory precedent"). However, in paragraph 566 it considers that their combined effect would be minor compared to the static consumer benefits estimated earlier and reaffirmed in paragraph 565. It then strengthens its pro-regulation conclusion by adding two asserted dynamic efficiency benefits (stimulated entry and investment in technology (paragraph 543)). Its overall finding is that "there are likely to be significant net benefits to consumers from the regulation of mobile termination rates where termination takes place on an existing non-3G network".

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18 These two quotations are respectively from pages 519 and 547 in Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E, *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, 1995.

3.4 We submit that this analysis is seriously flawed. In particular, the Draft Report:

- does not explain its criterion for distinguishing between dynamic efficiency benefits and detriments. In particular, it fails to address the problem that the effects it describes as benefits to dynamic efficiency could actually be detriments – welfare-reducing entry and investment;

- wrongly assumes that investment in 3G will not be distorted by the likelihood – based on the arguments in the Draft Report – that the Commission will propose to regulate 3G in future (in technical terms, the Draft Report ignores the time inconsistency problem);

- fails to acknowledge that what counts for dynamic efficiency is not what the Commission believes to be the implications of the Draft Report for the future regulation of 3G, but what investors are likely to believe are the implications;

- fails to analyse what investors are likely to believe (see section 4 below); and

- ignores producer surplus entirely in comparing dynamic losses with calculated static gains.

3.5 The Commission's failure to develop a framework for distinguishing dynamic efficiency benefits from detriments is puzzling. At paragraph 541 it acknowledges but ignores the NZBR's point that regulation could deter some welfare-enhancing investments while inducing some welfare-reducing investments. The Draft Report does not refer at all to international academic material on these issues or to a major local review on the issues by the Institute for the Study of Competition and Regulation. An important general conclusion from this review is that:

> … in markets where politicians and officials have concerns about efficiency, social-welfare maximising public policy will focus on dynamic efficiency and any impediments to it. This is because allocative and

> productive inefficiency will not persist in a dynamically efficient market, but policies focused on allocative and productive efficiency may have the unintended effect of reducing dynamic efficiency. Our model provides a rigorous representation of circumstances under which there will be a trade-off between static and dynamic efficiency, and suggests that there is a substantial risk that regulations aimed at perceived static efficiency problems will in the long run have the net effect of reducing efficiency in the market as a whole.[19]

3.6 It seems that the Commission has fallen into the error of assuming that a regulation that achieves static efficiency will also achieve dynamic efficiency and that innovations and entry induced by regulation must enhance dynamic efficiency. However, it is not true that all investment that is induced by intrusive regulation is dynamically efficient. The leading textbook referred to earlier makes the point that:

> Dynamic efficiency does not necessarily imply that firms invest at the greatest rate possible, but rather than there is a particular rate of investment that is socially optimal. More innovation is not always better because resources must be used in order to discover and adopt innovations. Although a competitive equilibrium results in static efficiency, it is not at all clear whether it results in dynamic efficiency.[20]

3.7 The same textbook sets out (eg at page 548) three options an investigator or researcher might use to assess the quantitative effects of regulation, taking dynamic efficiency into account. In our view the Commission should attempt to make use of all three approaches. In particular, it should look for comparisons between performance in regulated and unregulated markets, do 'before and after' comparisons that make use of market information concerning the effects of regulatory events on the market value of regulated firms, and adopt a time horizon for projecting the possible effects of regulation on dynamic efficiency that is much longer than five years.

3.8 We understand that on this occasion the Commission's various releases relating to the regulation of mobile termination have not had a discernible 'announcement effect' on Telecom's share price. (This contrasts with the situation in respect of the proposed local loop unbundling when the losses to shareholders (ie to a portion of producer surplus) dwarfed the hoped-for benefits from the proposed

19 Evans *et al*, p 34.

20 Viscusi *et al*, p 534.

regulation.) Unfortunately, the absence of an announcement effect does not prove the absence of a material negative effect on projected profits. Instead, it merely suggests that investors were not surprised by the announcement. We note that the Draft Report's calculated efficiency gains are miniscule in relation to the potential losses of producer surplus to investors in Telecom alone as a result of adverse share price effects from regulation.

4.0 Concluding comments

4.1 We doubt that the Commission is fully aware of the negative signals it is giving investors about the worth of investing in the future in dynamic technologies in network industries. There are many reasons why infrastructure investors in mobile technology are likely to interpret the Draft Report as a disincentive to such investments. These include:

- its insistence that the legislation is biased against investors – that it favours wealth transfers from investors to consumers;
- its failure to establish any principle that might limit the Commission's discretion to act arbitrarily in determining how heavily to weight consumer interests relative to producer interests;
- its failure to acknowledge that tolerance of excess *ex post* returns is essential as a balance against the likelihood of *ex post* losses;[21]
- its apparent view that anything less than the ideal of 'full' competition is limited competition;
- its apparent view that a finding of limited competition is tantamount to proving that excess profits exist in reality;

[21] Note, for example, that paragraph 555 does not contemplate the possibility that mobile operators will need to achieve a supernormal *ex post* return from ''efficient' investments if they are to achieve a normal *ex ante* return from a portfolio of risky *ex ante* investments.

- its apparent view that the normal private property right to exclude is evidence of market power;

- its narrow and uncommercial definitions of markets;

- the failure to understand that innovations that fail are normally socially beneficial, indeed they are intrinsic to the competitive process that allows consumers to determine the merits of competing products. Producers and consumers learn from both the successes and failures of products in the marketplace;[22]

- its notion that end users would be better off if there were no innovation than if the innovation were accompanied by supernormal returns for investors;[23]

- its failure to consider if excess returns (*ex ante* or *ex post*) are occurring in reality, taking into account the problems of joint cost, common cost and the lifetime of the investment;

- its adoption of a methodology for estimating indirect costs that in fact ignores all sources of indirect costs and biases decisions in favour of regulation by virtually ensuring that net benefits from regulation are positive; and

- the naivety of the view that investments in 3G will not be distorted by the threat of regulation in the light of the above, just because the Commission defers the regulation of 3G for now.[24]

4.2 This is a long and disturbing list. The Commission is quick to dismiss the outcomes from competitive processes on the grounds that they are imperfect, yet fails to hold the outcomes of state regulation to the

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22 For example, paragraph 534 states that innovations that failed consumed resources that might have been better used elsewhere. This is not a valid criticism of failed investments because it is also true for successful investments. The error here is to confuse *ex post* outcomes with *ex ante* expectations. As long as both successful and unsuccessful investments were *ex ante* efficient, there is no basis for regarding either as dynamically inefficient *ex post*.

23 For example, paragraph 556 asserts that investments that increase market power are unlikely to increase end user welfare. In fact, even under a 'pure' private monopoly no end users will buy the new products unless they benefit from the trade. End users are better off with a monopoly product on the market than with no product on the market.

24 Economists call this the 'time inconsistency' problem. A regulator who cares little for protecting the returns from sunk past investments cannot hope to generate confidence that the returns from future investments will be any better protected.

same yardstick. Economists call this unbalanced approach the Nirvana fallacy.

4.3 If the Commission were to hold state regulation to the same yardstick it would conclude that both market competition and regulation were imperfect. If the choice were then unclear to the Commission, the issue of the burden of proof might be decisive. Are competitive processes innocent until proven guilty, or does the Commission take the view that 'where there is doubt, designate'? From our reading of the Draft Report it is the latter. That would explain why it comes across as being so hostile to investment.

4.4 In our view, the Commission's interpretation of the legislation, particularly in relation to the burden of proof, the emphasis on static efficiency and wealth transfers is inconsistent with the stated purpose of the Act – to promote competition for the long-term benefit of end users. End users get no benefit from infrastructure investments that do not take place solely because investors are deterred by a hostile regulatory environment. We suggest that the Commission needs to put far more weight on achieving dynamic efficiency (properly understood). It is highly disconcerting to find policy concerning the purpose of the Telecommunications Act in such disarray and at such variance with established official and academic opinion.

4.5 The NZBR has commented on many occasions on the likely distorting effects of the Kiwi share regulation on investment and competition in New Zealand. When the charge for landline-landline residential calls is regulated at zero, the market must be distorted at the expense mobile operators. It would be natural to suppose that this has an effect on the volume and unit cost of mobile calls. We suggest that the Final Report should pay more attention to this issue in comparing New Zealand charges with overseas charges. It should also express its views on submissions, including our own, that the Kiwi share obligation should be terminated or substantially modified.

4.6 If the Commission wishes to assure infrastructure investors that it is not biased against them we suggest that the key issues it should respond to are those relating to its investor-hostile interpretations of the legislation, its apparent intolerance towards supernormal *ex post* profits from successful investments, the denial of a burden of proof for proposals for price control, the need for a long time horizon when considering the scale of indirect costs and overall profitability, the over-confidence about the objectivity and reliability of cost estimates, and the failure to take the indirect costs of regulation seriously. We suggest that the Commission should consult Treasury and the Ministry of Economic Development on the wealth transfer issue to determine if some legislative clarification might be desirable.

4.7 Given all the above problems with the analysis in the Draft Report, we submit that the only sound conclusion is that the Commission has not been able to adequately establish that the net static gains from the proposed regulation are positive or that, if positive, they are likely to exceed negative overall efficiency gains.

4.8 We submit that the Final Report should rule out price regulation on the grounds that the case for it is too inconclusive.