NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE TELECOMMUNICATIONS ACT 2001: SECTION 64 REVIEWS INTO UNBUNDLING THE LOCAL LOOP NETWORK AND THE FIXED PUBLIC DATA NETWORK

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Summary

- This submission on the Commerce Commission's Issues Paper of April 2003 on the *Telecommunications Act 2001: Section 64 reviews into unbundling the local loop network and the fixed public data network* (the Issues Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- This submission finds much to commend in the Issues Paper, particularly its acknowledgement of the importance of dynamic efficiency; the need for analysis to focus on the long term; and the proper identification of the problem a proposed regulation is intended to solve.

- The submission makes a number of suggestions for improvements to technical aspects of the approach set out in the Issues Paper. These relate to the definitions of "long term", "essentiality", the counterfactual, externalities, and the categories of costs and benefits. A general theme is the need for greater attention to the issues of problem identification, the rule of law and the protection of private property rights.

- On the important matter of the counterfactual that the Commerce Commission should adopt in its analysis, we stress the importance of choosing the best alternative rather than the 'most likely' alternative. In particular, we believe the Commission would not meet its statutory responsibilities if it fails to consider the alternative of light-handed regulation and the abolition of the Kiwi Share Obligations.

- As regards the substance of the unbundling issue, we see ample evidence that competition is intense for Telecom's (profitable) services and a disquieting

lack of analysis of the specific nature of any underlying problems. We commend to the Commission the structure set out in the Cabinet Manual for Regulatory Impact Statements, particularly in relation to problem definition and the identification of relevant alternatives. At this point we remain of the view that additional regulation is unjustified.

- We urge the Commerce Commission to adopt a presumption against intrusive regulation unless it is beyond doubt that the benefits markedly exceed the costs. If the Commission wishes to consider regulatory takings, we stress the need for the issue of compensation to be addressed in order to preserve the rule of law and incentives to make sunk investments.

1 Introduction

1.1 This submission on the Commerce Commission's Issues Paper of April 2003 on the *Telecommunications Act 2001: Section 64 reviews into unbundling the local loop network and the fixed public data network* (the Issues Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Telecommunications Act 2001 requires the Commerce Commission to investigate whether the unbundled elements of Telecom New Zealand's local loop network and its fixed public data network, as well as access to interconnection with that data network, should be regulated and made available to Telecom's competitors. The Commission must deliver a final report on these issues to the minister within 24 months of the Act's commencement, that is by 20 December 2003.

1.3 The Issues Paper sets out the Commerce Commission's:

- process for conducting the investigations, as governed by Schedule 3 of the Act;
- suggested decision-making framework for deciding whether or not to recommend regulation to the minister of communications;
- overview of considerations relating to unbundling, eg potential costs and benefits; and
- overview of international experience.

1.4 In undertaking its investigation, the Commerce Commission must consider the following purpose statement in section 18 of the Telecommunications Act 2001:

> (1) The purpose of this Part and Schedules 1 to 3 is to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand by

regulating, and providing for the regulation of, the supply of certain telecommunications services between service providers.

(2) In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand, the efficiencies that will result, or will be likely to result, from that act or omission must be considered.

2 Background

2.1 The Telecommunications Act 2001 marked a significant change in telecommunications regulatory policy, which previously relied on general competition law, the Commerce Act and the courts to regulate the industry. It set up a Telecommunications Commissioner within the Commerce Commission, and empowered the Commission to:

- resolve disputes between service providers over terms and conditions for interconnection with Telecom's fixed network, wholesaling of Telecom's fixed line services, number portability, roaming on cellular networks and co-location of cellular transmission facilities;
- make recommendations to the minister on any other services which should be subject to the Commission's dispute resolution powers;
- administer telecommunications service obligations (TSOs) set by the government to meet its social objectives. The Act empowers the government to declare new TSOs, subject to certain criteria and procedures, and declares the Kiwi Share Obligations with Telecom a TSO. The Commission is required to monitor compliance with TSOs, assess net costs where necessary, and allocate costs between telecommunications service providers;[1] and
- approve industry codes of practice.

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[1] The Ministry of Economic Development, at http://www.med.govt.nz/pbt/telecom/disability-access/ris.html, explains that the purpose of a TSO is to facilitate the supply of certain telecommunications services to groups of end users within New Zealand to whom these telecommunications services may not otherwise be supplied on a commercial basis and/or at an affordable price. It states that "the cost of any new TSOs will be borne by telephone service providers, and ultimately reflected in telephone service prices".

2.2 The Kiwi Share Obligations (KSO) agreement with Telecom was 'updated' in December 2001. It provides for:

- a free local calling option for all Telecom residential customers, including for standard internet services;
- a CPI price cap on the standard, nationwide residential line rental;
- Telecom to maintain the geographical availability of the network at December 2001 levels;
- a network upgrade by the end of 2003 so that 99 percent of residential telephone lines are capable of supporting an internet connect speed of at least 9.6 kbps; and
- a range of specific service quality standards and reporting requirements.

2.3 The NZBR was one of the few initial proponents of telecommunications deregulation in New Zealand. We have long opposed intrusive industry-specific regulation such as the 2001 measures and supported the earlier approach of (at most) light-handed regulation of telecommunications. There have been major benefits to the economy and consumers from this approach. In July 1998 we published a paper, *Regulation of Network Industries: The Case of Telecommunications*, which questioned the common assertion that local loops are a natural monopoly, urged rigorous analysis of whether Telecom was making profits or losses on the local loop, noted that the Kiwi share could be inhibiting entry, and suggested that further work be done on that issue if entry were seen to be a policy problem. The paper drew attention to the problems of information costs, the mixed incentives of regulators, and the uncertainty being created over property rights. We cautioned that the weakening of the rule of law could lead to disappointing outcomes from intrusive regulation.

2.4 In 2000 we made submissions on the issues paper and the draft report of the Ministerial Inquiry into Telecommunications. We opposed the proposal for an industry-specific regulator and considered that the powers and privileges proposed for the regulator would invite rent-seeking behaviour, undermine

the rule of law and facilitate the creation of entry barriers. We argued that there was a strong public policy case for terminating Kiwi share or universal service obligations.

3 Comments on the Issues Paper

3.1 The Issues Paper is commendable for its substantial and wide-ranging treatment of an important subject. It sets out its framework for analysis well, reviews international practice and literature, and acknowledges the complexities of the issues and the difficulties of coming to a final determination. We particularly endorse the following statements:

- "There are three forms of efficiency: allocative efficiency, productive efficiency and dynamic efficiency … The Commission takes the view that dynamic efficiency will generally better promote competition for the long-term benefit of end users" (p 19).
- The clear statement on p 33 that the starting point for the investigation is to determine "what competition problem unbundling is designed to address, and identifying whether such a problem exists in the New Zealand context".
- The proposed decision rule (p 51) not to recommend regulation if markets are competitive (in a workable or effective sense), and even where this is not the case on examination, to assess the case for regulation against the possibility of regulatory failure.

3.2 The following points in the Issues Paper are more problematical:

- ***Definition of the long term*** (p 20): The proposed definition stresses the concept of "sustainability", as in sustainably lower prices.

  The problem: We doubt that this concept reduces uncertainty in the minds of providers. Moreover, low prices, choice and variety are desirable outcomes of sound arrangements rather than independent goals. Lower prices *per se* do not mean higher welfare.

Suggested alternative: An alternative would be to specify that the long term must be long enough to allow for the replacement of sunk cost assets in network industries. Anything shorter implies that consumers can be made better off in the 'long term' by expropriating the sunk investments of incumbents.

- ***Definition of essentiality*** (p 34). The Canadian definition of an essential service is cited uncritically as one, *inter alia*, that *it is uneconomic for a competitor to supply*. The paper also uncritically cites the Federal Communications Commission (FCC) as supporting the supply of such services *at their economic cost*.

  The problems: The Canadian definition sets far too low a threshold in failing to distinguish essentiality from mere competitiveness and comparative advantage. The FCC's test is close to inoperable since economic cost is a subjective opportunity cost concept. It depends, *inter alia*, on the relevant counterfactuals and diverse perceptions of future developments. It cannot be measured objectively *ex ante*; unknown entrepreneurs determine economic cost *ex post*. In any case, there is no incentive to invest if the possibility of losses is not more than balanced by the possibility of excess *ex post* profits.

  Suggested alternative: It is critical to bring a sense of scale to distinguishing what is essential from what is just important or desirable. Air, food and water are essential for human survival. Beyond these, the Legislation Advisory Committee Guidelines are clear that a prime role of the state is to uphold individual freedoms and property rights.[2] The Commission therefore needs to set a high threshold for action that would take existing legitimate property rights from some citizens for the benefit of others. In short, a much higher threshold is required for government takings, and issues of consent and compensation need to be addressed.[3]

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2 *LAC Guidelines*, May 2001, section 2, chapter 3, p 40.

3 See *Constraining Government Regulation*, New Zealand Business Roundtable, November 2001 for a discussion of these issues.

- ***The definition of the counterfactual*** (p 50). The Issues Paper states that the most likely counterfactual is a continuation of the *status quo* [allowing for evolving technologies].

  The problem: Cost-benefit analysis requires the alternative under examination to be assessed against the best alternative. This is not necessarily the status quo or the 'most likely' alternative. The point needs emphasising because we understand that the status quo is not supported by any Regulatory Impact Statement. Unless the Commerce Commission identifies the best alternative it will fail in its duty to perform a competent cost-benefit analysis.

  Suggestion: In our view the Commerce Commission must analyse the options under consideration *inter alia* against the option of returning to light-handed regulation (no industry-specific regulation or regulation, but including the abolition of the KSO). This will allow it to identify the likely costs of the rent-seeking behaviour, political interference and fundamentally arbitrary bureaucratic decision-making that can be expected under the status quo.

- ***The categories of costs and benefits*** (pp 74-75 and pp 86-87). The Issues Paper identifies categories of costs and benefits that it proposes to assess in undertaking its cost-benefit analysis and asks for comments on them (including the issue of how network externalities should be handled).

  The problems: Most of the identified categories of benefits (such as the potential for increased competition, the promotion of entry, increased services, lower prices, greater investment by competitors and the avoidance of duplication) are not economic welfare benefits in themselves. To the contrary, many of them could reflect increases in costs. Changes in prices may signal a redistribution of income (eg from Telecom to other competitors) rather than a gain in the welfare of the representative individual. Less duplication may mean less flexibility. To improve efficiency a change must create an increase in the sum of consumer and producer surplus measured through time.

An alternative statement (that accords with the laudable focus of the Issues Paper on dynamic efficiency) is that the changes would generate net benefits only if they increase overall incomes – ie they increase output and the growth of output. A more general problem is that the list excludes the importance for economic welfare of the desirability of preserving the rule of law and protecting private property rights. These features are critical for dynamic efficiency.[4]

Suggestions: The key issue for the cost-benefit analysis is whether the proposed regulatory alternative is overcoming problems that could be better addressed by alternative arrangements. The existence of a bottleneck is not a problem in itself. First, to state that there are 'bottlenecks" does not establish that Telecom is not providing access to its facilities at a price that conforms to Commerce Act requirements. Secondly, it does not establish that bypass is infeasible when economic rents might exist. Thirdly, it does not explain why competitors do not simply take Telecom over if they do not like its access charges. Competitors or customers who want Telecom to unbundle could thus achieve this goal without any need for state action.

The Commerce Commission needs to pay greater attention to the issue of determining whether there is a problem that needs to be addressed and, if so, its nature. Only then can it hope to assess whether proposed remedies really deal with the underlying problem. In doing so it needs to build the issues of property rights and the rule of law into its analysis. We commend the steps set out in the government's Regulatory Impact Statements, particularly in relation to problem definition and the identification of alternatives.

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[4] Another problem is that the definition of an externality in paragraph 300 fails to distinguish an externality from simple scarcity – it treats A's decision to use a resource legitimately as an externality if it affects others for better or for worse. In a property rights context, a competitor that does not like Telecom's prices for interconnection can resolve the problem by buying Telecom's property right (eg through negotiation or, in the final analysis, by taking the company over, subject to compliance with the Commerce Act and the Takeovers Act). In short, the nature of any externality problem needs to be better defined and examined.

4 Concluding comments

4.1 We have argued in earlier submissions that competition is manifest and intense in telecommunications. As the recent activities of Counties Power demonstrate, bypass using fibre and wireless is commercially feasible on a large scale. Indeed, competition is so widespread as to create a rebuttable presumption that where it is not occurring it is because those services are not (yet) economic to provide. We have yet to be convinced that the benefits of more intrusive regulation exceed the costs.

4.2 Intrusive regulation raises costs directly, reduces flexibility and distorts investment. It politicises an industry and diverts resources that would be better spent on providing benefits to consumers into rent-seeking activities.

4.3 The rule of law requires governments to protect private property rights rather than expropriate them. As a result there should be a presumption against regulatory takings unless they are clearly necessary to achieve an essential public interest (eg as provided for in the Public Works Act). In such cases, the question of compensation should be addressed. The commercial reality that competitors may want cheaper access to Telecom's facilities should create no presumption in favour of unbundling. In our view, the Commission should ascertain if the forced unbundling would be a regulatory taking of Telecom's legally acquired property rights. If so, the detriments should be included in the cost-benefit analyses.

4.4 If the Commerce Commission finds that its cost-benefit analysis is fundamentally inconclusive because of a lack of reliable information about costs and benefits (as seems likely), we suggest that it should adopt a presumption against adding to regulatory costs and risks for no clear net benefit.

4.5 A pattern of imposing regulatory takings of sunk investments in the absence of any clear net benefit can only serve to deter future investment of an irreversible nature in network industries. Telecom has already made it clear that it has substantially reduced its capital expenditure in New Zealand as a result of regulatory burdens. Actual or threatened regulation concerning

mandatory roaming and cellsite co-location has also had implications for Vodafone's property rights, and provoked justifiable reactions from the company.

4.6 These are highly undesirable developments in major network industries. New Zealand businesses and households experienced the costs of under-investment in the telecommunications network in Auckland in the 1980s before deregulation and privatisation. We are now experiencing the cost of under-investment in electricity generation, largely as a result of intrusive state ownership and regulation (including the Resource Management Act and the implications of ratification of the Kyoto Protocol). It would be foolish not to heed these lessons and to repeat past mistakes in telecommunications.