NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE MINISTRY OF COMMERCE'S TELECOMMUNICATIONS INFORMATION DISCLOSURE DISCUSSION PAPER

DECEMBER 1998

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Summary

- This submission on the Ministry of Commerce's Telecommunications Information Disclosure Discussion Paper (the Paper) is made by the New Zealand Business Roundtable (NZBR), an organisation of the 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.

- The analysis in the Paper fails to distinguish between profits that arise from successful cost cutting, investment and innovation and profits that arise from the abuse of a monopoly position.

- Assertions that the local loop is a natural monopoly are no substitute for an analysis which substantiates such a conclusion. We doubt that any proper analysis would conclude the local loop is a homogeneous entity in terms of entry barriers.

- In our view, New Zealand's essential problem has been to make the transition from a dominant state-owned statutory monopoly to a competitive telecommunications industry while preserving incentives to invest and increase productive efficiency without too great a cost to allocative efficiency. It is not a problem of entrenched natural monopoly – as competition from cell phones and Saturn illustrates.

- From this perspective, New Zealand's achievements in telecommunications have been very encouraging, particularly in comparison with electricity where continuing government ownership, increasingly heavy-handed regulation and the expropriation of private investment values are key mistakes. We concur with the Paper's recommendation that optimised deprival values should not be mandated.

- We welcome the limited proposals in the Paper for less mandatory disclosure. However, in our view the general thrust of the Paper towards greater mandatory disclosure is the opposite of what is desirable. After a decade of increasing competition, the case for existing regulation is reducing and New Zealand should be looking at less, not more regulation.

- In particular, concerns about the Kiwi share should lead to a review of the rationale for maintaining its restrictions. The Paper's proposals for increasing disclosure regulation fail to acknowledge, let alone address, the fundamental information problems that arise. We believe they would not achieve their stated objectives and would be likely to generate pressures for more interventions.

- Our concern that increased mandatory disclosure of commercial information could lead to higher future prices due to a reduced willingness to invest in New Zealand (a loss of dynamic efficiency) are heightened by the possibility of perverse effects on evolving price competition between existing competitors.

- Given its lack of analysis of the source of industry profits and market structure issues, the Paper appears to reflect the view that markets cannot be relied upon to overcome entry barrier problems more effectively than regulators. This is the opposite of the conventional view that private goods are best provided privately without industry-specific regulation.

- Finally, we recommend that the Ministry adopt a policy of always including in discussion papers proposing regulations a section commenting on their conformity with the Code of Good Regulatory Conduct.

1.0 Introduction

1.1 This submission on the Ministry of Commerce's Telecommunications Information Disclosure Discussion Paper (the 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 discussion paper proposes increased disclosure of: prescribed services;[1] in particular the 0800 service; documentation of interconnection agreements; and financial information from Telecom, particularly in relation to the local loop. The paper also identifies a need for an economic assessment of the net cost to Telecom of its Kiwi share obligations.

1.3 The NZBR has a longstanding interest in these public policy issues. Our most recent contribution to them was the July 1998 paper *Regulation of Network Industries: The Case of Telecommunications.* This questioned the common assertion that local loops are a natural monopoly, raised the question 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 is seen to be a policy problem.

1.4 The NZBR has also had an interest in the analysis of issues associated with the mandatory disclosure of information. We opposed the mandatory disclosure of executive salaries under legislation which is now the responsibility of the Ministry of Commerce, noting in our submission the reasons why protection of certain information is vital for business efficiency. We suggested that, contrary to the interests of shareholders and the objectives of those advocating disclosure, the effect could be to increase executive salaries, which we believe has been the case. More recently, we commissioned Professor George Benston of Emory University to evaluate proposals for mandatory disclosure of information relating to investment products and financial advisers. His report, *Voluntary vs Mandated Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Product and Adviser Disclosure* (May 1997), included an insightful discussion of the potential costs of mandatory disclosure even to the group it is intended to assist. Concerns about the effects of this regime, which was promoted by the Ministry of Commerce, have subsequently been voiced by a number of other parties.

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[1] Services that primarily rely on Telecom's local loop for delivery.

1.5 The NZBR has supported New Zealand's approach of adopting (at most) light-handed regulation of private monopolies. The Kiwi share requirements and the disclosure requirements in section 5 of the Telecommunications Act 1987 are part of this framework. The competitive situation in the industry has changed enormously in the eight years since the current information disclosure regime was introduced and we agree that a review of its appropriateness is timely.

1.6 This submission explores the rationale for the proposed measures and their likely effects. Section 2 discusses the competitive state of the domestic telecommunications industry as it approaches the end of the first decade following the privatisation of Telecom. Section 3 focuses on the Paper's key proposals and the objectives they are intended to serve. Section 4 discusses those objectives from an information cost perspective. Section 5 discusses certain regulatory issues relating to the Kiwi share. Section 6 presents some concluding remarks.

2.0 Overview of New Zealand's experience with its current regulatory environment

2.1 In our view, New Zealand's experience with light-handed regulation of telecommunications is encouraging.[2] There have been impressive gains in productive efficiency[3] and in the quality and range of services. Despite the need for tariff rebalancing, unit prices for bundles of services have also fallen rapidly. The old concerns with the statutory monopoly provider about quality of service, network robustness, inability to determine a competitive strategy, and the capital expenditure constraints of a government owner are distant memories. Consumers

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2 In making this comment we put some weight on Professor Henry Ergas's remarks cited on page 23 of the July 1998 NZBR report. In our view, the Kiwi share constraints complicate the already complex task of making sound international comparisons. More research would be needed to establish any grounds for concern about New Zealand's regime from this perspective.

3 Telecom reduced its cost structure by 38 percent in real terms between 1987 and 1993 according to David Boles de Boer and Lewis Evans, 'The Economic Efficiency of Telecommunications in a Deregulated Market: The Case of New Zealand', *Economic Record*, 1996, 72, pp 24-35.

have responded by greatly increasing their use of telecommunications services. Massive and ongoing investment has taken place in the industry, much of it by new entrants.

2.2 A critical factor in this dynamic, high technology industry is that New Zealand has been able to avoid the heavy-handed regulation that poses such a threat to dynamic efficiency – government ownership, rate of return regulation and its close relative, CP-X regulation.

2.3 As in many other countries there have been a series of attempts in New Zealand to secure changes to the regulatory environment during the transition from a statutory monopoly structure. The pressure has fallen on those responsible for administering the Commerce Act and on ministers. Ministers have reacted by signalling a willingness to intervene on many occasions. The ongoing threat of future government involvement has surely influenced firms' competitive strategies, and not necessarily for the better.[4]

2.4 Compared with regimes that have sought to legislate or regulate for profitable entry, it has arguably been more difficult for new entrants in New Zealand to become profitable. But making entry easy for competitors is not necessarily consistent with consumer welfare maximisation. Consumers are not helped in the long run if regulation leads to the replacement of a single dominant provider by an artificially structured industry or a regulated cartel. Nor is it necessarily in consumers' longer-term interests to have regulators hastening the decline in unit prices by measures that take an incumbent's property rights without compensation and thereby reduce the future willingness to invest of the incumbent and other firms.

2.5 The fact that New Zealand has faced ongoing difficulties in extricating itself from the legacy of a statutory monopoly situation should be no surprise. It was always

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[4] See pages 35 and 36 of the July 1998 report for some criticisms of the government's intervention in respect of the Baumol-Willig rule following the Privy Council decision.

going to be difficult for Telecom and its competitors to negotiate agreements about such matters as interconnection and numbering plans. As with the opening up of the airline and television markets to competition, New Zealand's arrangements rightly encourage the incumbent to be a vigorous competitor, while restraining abuse of a dominant position. The problem is that regulators, entrants and incumbents may be unsure as to whether any specific conduct oversteps this mark. This inevitably means a level of uncertainty about property rights. If it were not for the government's revealed willingness to override court decisions, this uncertainty might be expected to fall through time as court decisions clarify the law.

2.6 Arguably many of the difficulties New Zealand has faced in making the transition from a statutory monopoly reflect information problems and incentives to 'game' the regulatory system. The fundamental regulatory problem is that it is impossible to objectively determine future costs. Future costs are particularly problematic when technologies are changing rapidly. Without knowledge of opportunity costs, economists cannot determine the level of marginal cost. This means that they cannot readily determine if there is a gap between marginal cost and price. Nor can they tell if there is a gap between marginal cost and average cost. Normal profits result when average revenue equals average cost. There is only one volume of sales at which marginal cost equals average cost. When volumes are changing fast there is no reason to expect that the actual volume of sales will allow marginal cost to equal average cost. Pricing at marginal cost could result in supernormal profits or losses, depending on the volume of sales. Any such profits would be called economic rents by economists and would not be a cause of concern.

2.7 These information problems are largely intractable, except through market processes (see the next paragraph). They challenge politicians, experts, regulators, new entrants, a dominant incumbent and the courts under any set of regulatory arrangements.

2.8 Market processes provide the most satisfactory solution to the problem of deciding whose views should prevail when views about the future differ. Views about the evolution of future costs are fundamentally entrepreneurial. Market processes allow consumers to answer spontaneously and in an uncoordinated manner the question as to whose views will prevail.

2.9 Regulators are much less informed than markets about consumer preferences and lack the incentives to make the best choices. Regulations can force an incumbent to provide information about current and past accounting costs, but they cannot produce objective information about future costs or the value of forgone alternatives.

2.10 The need for regulation should reduce through time if the problem is essentially one of transition from a statutory monopoly. Undoubtedly, many of New Zealand's regulatory difficulties arise from the dominance achieved by a government-owned statutory monopoly. However, if there is also a problem of natural monopoly, competitive entry cannot be expected to occur, at least until technological change removes the entry barrier implicit in the incumbent's much lower marginal cost of production.

2.11 The Paper's proposals are based on the premise that some of Telecom's activities are a natural monopoly. References to Telecom as a natural monopoly are made in paragraphs 62, 67, 72 and 83. (Paragraph 72 concedes that technological changes are eroding natural monopolies over time.)

2.12 Is the Ministry indulging in rhetoric or does it have some body of analysis to justify these assertions of a fundamentally intractable problem? On what basis do officials disagree with the views of Nobel laureate Gary Becker and other economists who do not see telecommunications as a natural monopoly? Most obviously, the ubiquitous cell phone readily bypasses much of the local loop. Furthermore, converging technologies, falling call charges and the growth of the Internet are generating enormous call volume growth and large investment requirements. How can officials explain the entry of Saturn in greater Wellington

if they see the local loop as a natural monopoly? In our view it is important that officials answer these questions in order to establish that the analysis underlying their proposals is soundly based.

2.13 The regulation of local loop pricing would be difficult if the local loop really was a natural monopoly. By definition, with a natural monopoly pricing at marginal cost would mean pricing below average cost. While economists preach the virtues of marginal cost pricing once capacity is installed, such pricing would be a threat to future investment. It may also make the incumbent vulnerable to a predatory pricing charge under the Commerce Act (the Commerce Commission's recent investigation of Telecom's response to Saturn's prices in the Hutt Valley illustrates the potential for such actions). In any case, marginal cost pricing is not commercially viable for the incumbent in these situations. Only if a for-profit incumbent expects future revenues to at least cover the average cost of a future investment can the investment be expected to be forthcoming. Regulations or court decisions that prevent profits from exceeding average cost for any sub-period could deter investment by denying the opportunity to recover losses in bad years from offsetting excess profits in good years. It is therefore important that this issue is resolved.

2.14 In contrast, if the natural loop is not a natural monopoly the prime issue is to allow competitive entry to erode the dominance arising from the former statutory monopoly if alternative providers are more efficient, without distorting the competitive process for no good reason.

2.15 It is also plausible that the local loop is far from homogeneous with cost structures varying geographically and by segment of service. Disclosure requirements that relate to the loop as a whole, or to mis-specified portions of it, may be of little value in relation to the Ministry's objective.

3.0 The Paper's proposals

3.1 The Paper proposes (in paragraph 28) that there be less regulation of information concerning international calls and leased services prices and discounts because extensive competition now exists for these services. We fully endorse this approach but question the Paper's qualification that this approach should only be supported if information is provided that "clearly demonstrates that these markets are now fully contestable". The term "fully contestable" is undefined, but it has connotations of an unrealistic zero transaction cost world. Consumers currently have ample choice and competition is vigorous with prices falling sharply.

3.2 The remaining sections of the Paper propose extensions to the range of information that must be provided by Telecom. The Paper states that the additional information is required in order to:

(i) assist Telecom's competitors by forcing it to publish commercial pricing information, particularly in respect of 0800 number discounts (see section 3.4, particularly paragraph 26) and interconnection agreements (see section 4.4);

(ii) facilitate international comparisons (see section 3.5);

(iii) help Telecom's competitors determine whether Telecom's KSO-related access charges are reasonable (see section 4.3, particularly paragraph 48); or

(iv) help assess whether Telecom is using charging too much for its so-called natural monopoly services and subsidising contestable activities (see section 5, particularly paragraph 62).

3.3 Paragraph 89 is quite explicit about the objective of facilitating competition by "bringing more pressure to bear on Telecom's prices and profits".

4.0 Discussion of the objectives of further mandatory disclosure

4.1 Information is costly to produce. Mandatory disclosure of private information reduces voluntary incentives to produce the same information. Where the information is provided for the public good, mandatory disclosure is a taking of private property. It is thereby analogous to the taking of private land for public works. Payment of compensation for such a taking would be needed to restore incentives to produce such information in future on a voluntary basis.

4.2 These costs are increased where commercially sensitive information is involved. The forced publication of that information is a free gift to competitors. As such it could induce competitive entry. One possibility is that a greater level of entry results in lower prices to consumers in the short term than would otherwise occur. A second possibility is that disclosure will make it easier for cartels to form by reducing the costs of verifying that the incumbent is sticking to any implicit industry understanding. A third possibility is that mandatory disclosure will reduce the ability of an incumbent to recover common costs by efficient Ramsay pricing. A fourth possibility is that forced disclosure of special discounts will lead to higher prices for the relevant services than would otherwise occur, with no guarantee of comparable offsetting benefits to other customers. In all these cases, the longer-term effects on dynamic efficiency and therefore on consumer prices are likely to be unfavourable. This reflects the near-inexorable likelihood of a trade-off between dynamic efficiency and regulation designed to improve allocative efficiency.

4.3 There is also a risk that the costs of mandatory disclosure requirements will increase over time. This is because the stated objectives are open-ended. As long as the incumbent retains some private information, competitors and those seeking to make international comparisons would always be assisted (other things being equal) if more of it has to be published.

4.4 As argued in section 2, the fundamental problem in respect of the monopoly issue is that it is future costs, not past costs, that are relevant. Future costs are

subjective. There can be no end to the debate as to whether the information disclosed is accurate or adequate. As long as competitors do not have to pay for information, they will always have an incentive to clamour for more as long as the marginal benefit is positive. In our view the greater level of disclosure that the Paper proposes would fail the same tests that it applies in coming to the conclusion that current requirements are inadequate.

4.5 Regulating to put more pressure on Telecom's profits and prices is not necessarily consistent with dynamic, allocative or productive efficiency. What is required instead is an analysis of price in relation to marginal cost, not price in relation to average cost. Regulating to reduce the profits of a firm which has been very successful in reducing average costs is likely to make all potential investors wary of New Zealand. Public policy needs to be particularly careful therefore to be seen to be identifying and addressing a monopoly problem. To fail to distinguish between successful cost cutting and innovative development of new products on the one hand and the abuse of a monopoly position on the other would do no service to New Zealand consumers.

5.0 The Kiwi share

5.1 In our view, New Zealand's experience to date reflects the problems of moving from a totally dominant, publicly owned statutory monopoly to a private, competitive, multi-firm industry, rather than the enduring problems of a natural monopoly. The vast majority of new entrants have focused on competing for tolls and business services. Presumably this is where the economic rents were the highest and/or entry was the easiest. Certainly, prices have been reduced most in this area. But this does not mean that there would not have been more competition in the local loop in the absence of the Kiwi share.

5.2 To the degree that the Kiwi share has prevented Telecom from raising local loop charges, it has arguably restricted returns and thereby raised barriers to entry to the local loop. The NZBR has repeatedly called for a review of the case for continuing with the Kiwi share restrictions.

5.3 There are two possible reasons why the government might be concerned to preserve the Kiwi share. One is that it believes that the Kiwi share is forcing less politically important groups to cross-subsidise important users – and it wants to preserve these cross-subsidies as long as possible. The comments in the Paper about losses (eg in paragraphs 46, 48, 51 and 52) suggest that officials find this hypothesis plausible. The alternative reason is that it believes that the local loop is a monopoly and is concerned to stop monopoly charges for local lines.

5.4 The first motivation would be inconsistent with the objective of economic efficiency. A much sounder approach would be for parliament to explicitly debate such subsidies, and to fund them transparently should it desire to do so. If Telecom is making losses because of forced subsidies it should be possible to negotiate terms under which it would purchase its way out of the existing requirements.

5.5 Although local lines do not appear to be a natural monopoly, some monopoly pricing may be possible during the transition from a statutory monopoly. Telecom's competitive response to Saturn's entry in Lower Hutt demonstrates the scope for competition in the local loop to drive down prices. Saturn's entry into Auckland could have a similar effect on prices in that region. Two things could affect Saturn's decisions (or those of any other potential competitor). The first is its perception of Telecom's willingness and ability to cut prices in Auckland as significantly as it did in Lower Hutt. In the absence of government regulation, any competitor would surely presume that the law of one price must prevail for a commodity product, as the recent petrol price reductions illustrate. On this view, Telecom must be expected to cut prices to the extent necessary to remain competitive in Auckland. Saturn has indicated that it will delay a decision on entry in the hope that the government will intervene on its behalf. As long as it perceives the probability of such intervention as being material, such a strategy would be consistent with shareholder value maximisation regardless of what decision it actually takes in future. This game-theoretic situation simply demonstrates that the threat of regulation has the potential to delay otherwise

profitable entry. But the government should hesitate to stop Telecom from reducing prices selectively to Aucklanders in the hope that this will facilitate Saturn's entry for the obvious reason that governments have no sound basis for depriving Auckland consumers of lower prices for the benefit of a new entrant.

5.6 Secondly, Saturn's entry decision in Auckland could also be delayed by its perceptions that the government desires to regulate so as to lower access charges for those seeking interconnection. The Paper's focus on assisting competitive entry by those not competing with the local loop leads it to ignore the implications of any interventions for those seeking to compete with local loop services (see, for example, paragraphs 26 and 48). If lower charges for the local loop prevent further competitive entry, the same competitors will use the absence of entry to argue that entry barriers, and therefore Telecom's charges, are still too high. Such a treadmill would be a threat to all investment in the local loop.

5.7 To conclude, in our view it is critical for dynamic efficiency that public policy does not undermine incentives to invest in the local loop. Talk of losses arising from the Kiwi share and the focus of the Paper on reducing returns to the local loop at a time when demand for its services is growing very fast only serve to heighten these concerns. The Paper needs to acknowledge the reality of new competitors such as Saturn and to consider explicitly the effect of its proposals on incentives to invest in the local loop.

6.0 Concluding comments

6.1 In our view, less not more regulation in network industries where competition is increasing is desirable with the passing of time. The key mistakes in electricity have been the continuation of government ownership, the drift into rate of return regulation through the use of optimised deprival values, and the desire to transfer value from taxpayers and shareholders to consumers for short-term political reasons. We are particularly concerned about the implications for New Zealand's reputation in the eyes of investors of any continuing indications of governmental willingness to expropriate property rights of incumbents without compensation.

6.2 Any concerns about 'natural' monopoly are much less warranted today than they were in 1989. Assertions about natural monopoly do not suffice to justify the proposed interventions. In our view, the proposed regulations will fail to achieve the objectives officials have in mind. The objective in relation to the cost of the Kiwi share appears to be particularly ambitious given the international difficulties discussed above. Disappointing outcomes will generate demands for further regulation. There is no satisfying such open-ended demands. A cost-benefit approach must be taken to all regulatory proposals.

6.3 The continuing existence of the Kiwi share constraints is hampering the development of competition and prolonging uncertainties about the government's attitude to hidden cross-subsidies. Rather than increase the amount of regulation associated with these constraints, the government should review their continuing rationale. The elimination of unjustified restrictions could well help overcome some of the problems perceived by Telecom's competitors.

6.4 Finally, there is no indication in the Paper that its proposals conform with the Code of Good Regulatory Conduct. As a matter of principle, the Ministry of Commerce should set an example in this area by making it a matter of policy that all its regulatory proposals contain a statement of their consistency with that Code.