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NEW ZEALAND
BusinessROUNDTABLE
PROMOTING POLICIES FOR A BETTER NEW ZEALAND

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TSO Reform
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TSO Review (2009) Discussion Document

This submission on the Discussion Document is made by the New Zealand Business Roundtable, 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 national interests.

In our view the general context in which policy related to the Telecommunications Services Obligation (TSO) should be set is the government's goal of closing the per capita income gap with Australia by 2025. Achieving that goal will require a sustained commitment to the adoption of institutions and policies of the highest order. Policy proposals that do not meet that standard should not be adopted.

General

We have three general concerns about the Discussion Document.

(i) Since 1 April 2008 the Cabinet Manual has required government departments releasing discussion documents containing regulatory proposals to include a Regulatory Impact Statement or be based on a similar framework. The purpose of this requirement is to improve the quality of regulations by ensuring they are based on rigorous economic analysis which submitters have an opportunity to critique and which can serve as a basis for their responses. The Discussion Document contains no such analysis. The Ministry of Economic Development is an important regulatory agency which previously had responsibility for overseeing the quality of regulatory proposals. It should be setting a standard in this regard. In the recent Government Statement on Regulation the government has asked to be held to account in respect of its commitment to less and better regulation. We wish to do so by asking the Ministry to issue a new TSO discussion document that conforms with the Cabinet Manual requirements and is certified as adequate by the Regulatory Impact Analysis Unit of the Treasury.

(ii) A major part of the proposal in the Discussion Document is to establish a $300 million fund to invest in the Rural Broadband Initiative which is a part of the government's wider Ultra-Fast Broadband Investment Initiative. We have sought from MED the economic analysis behind the government's broadband initiative but our request was transferred to the Minister for Communications and Information Technology in a letter dated 13 October 2009. We infer that no such analysis has been undertaken by MED, and we have not yet heard from the minister. We suspect that it does not exist. In that event MED should not be proposing a levy to fund the RBI without undertaking such an analysis and making it publicly available. Otherwise there is a serious risk that resources will be wasted and economic growth undermined. We ask that such an analysis is presented in a revised discussion document.

(iii) What is proposed is a form of industry regulation to fund what is essentially a social welfare service. This runs counter to longstanding policy that such services should be established only on the basis of need and funded from general taxation. Policy on state-owned enterprises provided for such funding for social reasons, for example for postal services for rural subscribers, but this has long since been considered unnecessary. In our view any case for social service provision should be required to compete with other social welfare priorities out of a relevant vote.

Specific comments on the Discussion Document

Local Service TSO

The Discussion Document states that the Local Service TSO is primarily a consumer protection mechanism and ensures the availability and affordability of basic telecommunication services in rural New Zealand.

The Discussion Document is deficient in not examining the fundamental case for the TSO as a public policy objective. A first principles approach to the issue should do so. It is not clear to us that there is a good case for mandating any form of universal service. There are no comparable mandates for many other goods and services (eg electricity and transport) that are delivered to remote consumers. The cross-subsidies that arise result in a misallocation of resources at the margin and reduce the economy's growth potential. They may also be inequitable in many cases, with less well-off customers subsidising better-off ones. This was a finding of a 2003 New Zealand Institute of Economic Research study which recommended the abolition of the TSO. The TSO is comparable to the former national pricing policies which required the supply of goods such as petrol to rural customers at urban prices. These have long since been abandoned as distortionary and unjustified.

If the TSO were removed, we have little doubt that telecommunications carriers using a variety of technologies, such as copper, cellular, cable, wireless and satellite, would find ways of serving a large number of the beneficiaries of the TSO without subsidy. Telecom would not lightly shed customers, and would be under public pressure to maintain widespread services. We understand that already some 70 percent of so-called commercially non-viable customers are covered by cellular networks. Arguably those who might not be commercially viable should meet the full costs of the services they use.

Scrapping the TSO entirely would also avoid the substantial annual costs of its administration. In the Discussion Document these are put at $600,000 for the Commerce Commission alone, and the costs to industry participants may be similar or greater. These costs are pure economic waste.

A further piece of flawed economic analysis in the Discussion Document is the statement in paragraph 37 that:

> The current method of determining the TSO charge for local service does not recognise the full benefit Telecom receives from profitable customers in urban areas. The large surpluses Telecom makes for many urban areas do not go to offset the unprofitable customers in remote rural areas.

This is an extraordinary proposition. Telecom faces multiple forms of competition in urban areas and there is no suggestion in the Discussion Document that excessive profits are being made. There is no economic case for forcing Telecom to cross-subsidise unprofitable rural customers. Firms may choose to supply services to customers at below marginal cost for commercial reasons, but there is no case for mandating such cross-subsidisation. This idea should be discarded. Moreover, if, as envisaged by MED, the TSO is retained and assessed as zero, Telecom and its shareholders would obviously suffer a loss. This raises a possible issue of compensation in terms of the Legislation Advisory Committee Guidelines. Whether a property rights taking is involved would be for a court to decide, but we ask that MED address this issue in a revised discussion document.

If these arguments for scrapping the TSO are not favoured, the presumption must be that there is a case for maintaining cross-subsidies on social grounds. In this event logic suggests that the costs should be met by taxpayers on behalf of the community at large, not other carriers or users of telecommunications services. It is ironic that MED proposes to impose a specific tax on what the government deems to be an underperforming sector of the economy in order to meet social objectives. A specific tax is necessarily associated with higher deadweight costs than efficient income and consumption taxes. Funding any social subsidy from general taxation would make what are currently hidden costs transparent and provide a basis for ongoing debate, in the context of parliamentary appropriations, as to whether such expenditures are justified on social grounds.

Free local calling

The Discussion Document notes that free local calling and the current price cap on monthly rentals are part of the Local Service TSO but it fails to examine these aspects. In our view a document that purports to be about 'TSO Reform' should do so. Free local calling has become increasingly archaic with the development of technologies that do not involve local calling areas (eg mobile and VoIP) and with the emergence of services other than voice, such as internet. Few other countries, including Australia – the government's benchmark country – have our regime. It again involves cross-subsidies, as heavy users (for example of the internet) require carriers to install greater capacity than would otherwise be the case and spread the costs over other users. This too is inefficient and inequitable.

Free local calling also has an effect on the objective of promoting broadband. An OECD study suggests that free local calling for internet dial-up reduces broadband uptake.[1] If wider access is the pre-eminent concern, then free local calling directly contravenes this objective. Under free local calling, those valuing calling most (ie those who make the most calls) are heavily subsidised by those valuing calling least (ie those who make the fewest calls). Free local calling encourages high users to substantially over-consume, pushing up the total cost of service for all users, but predominantly at the expense of those valuing calling least (and hence the most likely not to purchase a connection if the price rises). This tendency undermines penetration targets for connections, the business case for serving a region, and the achievement of the social objective. Most regimes promote wider connectivity by using calls to subsidise connections, not vice-versa. To induce competitive entry, and to allow the operator to recover costs, it is logical to allow a regime where call revenue can be used to recover fixed costs. This is precisely the reason why prepaid mobile phones (zero monthly charge, higher-priced calls) have diffused widely and quickly – low call makers still have one, increasing network effects and connectivity, but make calls only when the benefit exceeds the cost. As over 60 percent of New Zealand mobiles are prepaid, it is reasonable to speculate that a regime requiring 'free mobile calling' and mandatory monthly fees would have virtually killed the New Zealand mobile market. Maintaining the free local calling regime for a fixed line operator suppresses the development of the fixed market and distorts competition between the two forms of connectivity.

Free local calling imposed on Telecom but not its competitors introduces a distortion in costs that is currently affecting competition in the broadband market. As Telecom must offer both free local calling and universal service rentals, it is charging all consumers in all markets a price that reflects a weighted average cost across all areas. Heavy dial-up internet users impose higher PSTN costs than broadband internet users, but all telco-based internet users must purchase a fixed line, the price of which is determined by the (weighted average) price Telecom charges. Its competitors can target those customers already using broadband (or about to switch from dial-up to broadband), thus creating an 'adverse selection' problem whereby entrants have a disproportionately large share of the low PSTN users and Telecom a disproportionately large share of the high PSTN users. Historically, the TSO could have been used to redress this imbalance. But without it, the adverse selection problem will get worse (no entrant wants to assume service of dial-up internet users – Telecom will get left with them all and will have to raise its PSTN charges and so will the entrants, as it is still necessary to purchase a PSTN line to get a DSL connection). This remains an issue as only just over half of internet users have

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[1] OECD http://www.oecd.org/dataoecd/34/34/39360525.pdf, footnote 18 on page 30.

DSL accounts. The Discussion Document has not even contemplated this issue. Getting rid of free local calling solves the problem.

For these reasons we ask MED to explore options of moving away from universal free local calling. In effect, two government policies (TSO and RBI) work in opposition to each other. The first levies the ICT sector to control retail prices for local calls and the second levies the ICT sector to subsidise broadband deployment in competition with free local calls. It may well be that some carriers would be willing to offer free local calling, perhaps subject to a limit on calls, as one package among a range of others. An assurance of this sort might ease political concerns. The analysis would also focus on different services (voice, fax, internet etc) and the case, if any, for a mandate on each of them separately. In any event we see no reason why a user pays approach, which would stimulate innovation to serve customers at least cost and level the playing field for other services such as mobile, should not apply in this area.

Related issues

We also raise for consideration other aspects of the original 'Kiwi Share' that gave rise to the TSO which are not covered in the report. An example is the foreign ownership restriction on Telecom. We are not clear that this is justified and it may be imposing economic costs, for example by shielding Telecom from takeover and/or preventing foreign investors from bringing managerial and other benefits to the company through an ownership stake. We see no reason why normal foreign investment rules should not apply to Telecom. The government should give serious consideration to abolition of the outdated Kiwi Share.

Conclusion

Paragraph 78 of the Discussion Document notes that:

> Implementing the proposed TSO reforms would require:
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> - Making regulations for setting a net cost TSO charge to Telecom for local service based on cross subsidisation at a national level (by invoking the regulation making powers in section 101 of the Telecommunications Act).
> - Phasing out TSO levies as the funding source for payment of TSO charges (by amending the Telecommunications Act).
> - Phasing in a process for payment of TSO charges by the Telecommunications Development Levy Fund (by amending the Telecommunications Act).

All these measures would have to be supported by a Regulatory Impact Statement certified as adequate by the Minister and the Regulatory Impact Analysis of the Treasury (in terms of the new procedures established under the Government Statement on Regulation). Rather than postpone such analysis to that stage, we consider a much more satisfactory process would be for a new Discussion Paper containing such an analysis to be prepared and exposed for public comment before government decisions are made. It should start with a first principles investigation of whether the TSO is justified as an element of social policy. Unless this analysis demonstrated a compelling case for retention, we consider that the TSO, free local calling and other elements of the original Kiwi Share should be abolished. Similarly any public investment in broadband should be supported by a robust economic analysis and, if found justified, funded out of general taxation or borrowing. New Zealand cannot afford to maintain second-best policies if the government's growth objective is to be achieved.

Yours faithfully

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cc Regulatory Impact Analysis Team
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