NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE MINISTERIAL INQUIRY INTO TELECOMMUNICATIONS DRAFT REPORT

JULY 2000

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Summary

- This submission on the Ministerial Inquiry into Telecommunications (the Inquiry) Draft Report (the Draft Report) of June 2000 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 should be read in conjunction with our submission in May 2000 on the Inquiry's Issues Paper.

- In our view the measures proposed in the Draft Report represent a major potential setback for the telecommunications industry in New Zealand. They could seriously deter further investment in facilities by those who have made the greatest investments in New Zealand. The Draft Report's recommendations put at risk the very objective of a dynamic and efficient industry that its authors espouse.

- Section 2 of this submission analyses the Draft Report's reasons for recommending an industry-specific regulator and fails to find any basis for concluding that the likely benefits exceed the costs. In our view, the proposed powers and privileges for the regulator would invite abuse, undermine the rule of law and facilitate the creation of entry barriers.

- Section 3 examines the broader question of the Draft Report's reasons for advocating more intensive regulation of the industry. It finds that the Draft Report appears to be based on an unexamined view that the profit motive is not enough to ensure that new technologies are introduced to New Zealand in a timely manner. This appears to lead it to believe that regulation to increase the number of competitors is necessary. This view appears to drive much of its analysis.

- Section 4 analyses the arguments for mandating supply even in the absence of any evidence of wrongdoing by a dominant incumbent. It fails to find a satisfactory case. To the contrary, it finds serious grounds for concern about the effects of such a requirement on dynamic efficiency. Moreover, mandating supply could violate the conventional equity criterion that it is undesirable for policies to transfer wealth from the poor to the well off.

- Section 5 uses these findings to examine the Draft Report's criteria for designated electronic services. We find that these criteria represent a threat to economic efficiency, particularly in respect of future investments by major participants. If applied to existing investments not covered by the Kiwi Share, the issue of compensation for regulatory takings should be addressed.

- We conclude that New Zealand should allow all entities to have full property rights in their investments as long as they comply with existing laws of the land, including the Commerce Act. Mandating supply of capacity to competitors does not appear to be justified.

- Section 6 examines the Draft Report's proposed regulatory pricing principles. As the Draft Report itself indicates, every option is flawed. International benchmarking is crude, imprecise and therefore open to political and bureaucratic manipulation. A regulator's assessments of forward-looking costs are subjective matters of opinion about the future by an entity that is not putting its own money on the line. All too often they are likely to be seriously wrong. The Draft Report appears to use double standards in dismissing light-handed regulation for not producing a clear set of principles when it is unable to suggest how an industry-specific regulator could solve the problem satisfactorily.

- Section 7 recommends against any state-backed industry forum. If there is to be such a forum, it recommends that its decisions ought to be unanimous in order to reduce the risk of capture by self-serving factions.

- Section 8 argues that there is a strong public policy case for terminating Kiwi Share or universal service obligations rather than expanding them as the Draft Report recommends. We question them in terms of efficiency and equity. The

case for them as a device for easing the transition from a state-owned statutory monopoly situation is now largely in the past. In any case, we suggest that the Kiwi Share obligations should be treated as a contract between the Crown and Telecom so that any variation in their terms should be a matter for mutual renegotiation as distinct from an act of *force majeure* by the Crown.

- Section 9 endorses the Draft Report's emphasis on improving the balance between the costs of complying with information requirements and the likely benefits.

- Section 10 argues that the biggest contribution the government could make to allowing all New Zealanders to participate in the new technologies would be to focus on the issue of adult literacy and the performance of the public school system. It rejects the argument put forward for a state-backed information society initiative funded by an industry levy.

- Section 11 argues strongly against the Draft Report's reasons for its proposed restrictions on the use of the spectrum.

- Finally, we have major concerns that the path that the Inquiry would have New Zealand embark upon would lead to more and more intrusive regulation, as has been the pattern in other countries. If, contrary to our submissions, the Inquiry maintains its proposals in its final report, we recommend that it should suggest a review date for the entire regulatory edifice.

1 Introduction

1.1 This submission on the Ministerial Inquiry (the Inquiry) into Telecommunications Draft Report (the Draft Report) of June 2000 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.

1.2 This submission should be read in conjunction with our submission in May 2000 on the Inquiry's Issues Paper.

1.3 We discuss our response to the Draft Report under the following headings:

- The Draft Report's case for an industry-specific regulator
- The Draft Report's grounds for intervention
- Mandated services
- Criteria for designated services
- Pricing principles
- An industry forum
- The Kiwi Share and universal service obligations
- Information disclosure
- Information society initiative
- Spectrum allocation and management.

2 The draft Report's case for an industry-specific regulator

2.1 Section 3.6.2 of the Draft Report summarises the Inquiry's reasons for concluding that "consistent with the view held by other countries, industry-

specific regulation is warranted". The summary comprises four bullet points. We discuss each in turn.

2.2 The first reason refers to "significant delays" in negotiating commercial agreements between competitors. This begs the question as to how fast issues have been resolved in recent years compared with the speed elsewhere and as to what is the optimal speed. Given the complexity of the commercial negotiations, how does the Inquiry know if the delays signal a problem? Any government can attempt to short-circuit commercial negotiations by mandating quick-fix, binding dispute resolution processes. But if such attempts did result in speedier settlements, is speed is necessarily a virtue in resolving complex commercial negotiations? The issue here is whether imposed solutions are likely to work better than mutually agreed solutions reached through more protracted voluntary processes. If the effects of a decision are going to be felt for many years, is it better to have a possibly bad and divisive decision reached in a few weeks or a better and more amicable decision in a few months? The Draft Report fails to consider this question. Imposed long-term arrangements have the potential to turn those who are parties to them into bitter and disputatious enemies who cannot part yet cannot work together. Commercial relationships depend for their success on mutual goodwill.

2.3 The discussion in the previous paragraph assumed what the proponents of industry-specific regulation would have us presume – that such a system means less litigation and faster dispute resolution than generic, light-handed regulation. However, there should be no such presumption beyond the short term. The unending regulatory proceedings that are a feature of industry-specific regulation of telecommunications in Australia and the increasing recourse to the courts point to the possibility that it is lawyers, not consumers, who will reap a bonanza from industry-specific regulation[1]. Indeed, any delays observed in New Zealand may be due in part to the uncertainty about the allocation of property rights that inevitably accompanies antitrust

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[1] See, for example, the comment by Henry Ergas, in Richard Epstein, *Telecommunications Regulation*, New Zealand Business Roundtable, May 2000, pp 28-29.

regulation. It would clearly be unwise to use those delays to justify further intrusive regulation.

2.4 The Draft Report's second reason for favouring industry-specific regulation is that it expects that a range of new issues (such as a need to mandate access to roaming facilities) will emerge that governments will have to address if "effective competition" is not to be hampered. This reason reflects two highly questionable presumptions in the discussion leading up to section 3.6.3. The first is the effective adoption of an essential facilities doctrine (see below). The second is the belief that welfare is maximised by "effective competition" based on counting heads.[2] However, where economies of scale are large in relation to the size of the market, a small number of firms may be efficient. Furthermore, the opportunities for collusive or oligopolistic behaviour depend heavily on demand conditions, entry barriers and the rate of technological change. Finally, there is the major concern in the regulatory literature that the establishment of an industry-specific regulator will lead to higher entry barriers in the future than would otherwise occur. For example, a regulator may induce entry by making decisions that are unfavourable to a dominant incumbent, but may subsequently feel obliged to ensure the success of the new entrants by protecting them from further competition. A particular concern here is that on page 20 the Draft Report proposes that any agreements and codes of practice authorised by the Commissioner be immune from challenge as being anti-competitive under the Commerce Act. The Draft Report does not discuss the implications of these possibilities.

2.5 The Draft Report's third reason for favouring industry-specific regulation is that other arrangements have not provided consistent or clearly articulated guidelines. This presumes that such guidelines exist, can be discovered by industry-specific regulation, and will prove to be sustainable in the face of political lobbying. The Draft Report states that "most other countries" have had industry-specific regulation, but fails to provide any evidence that any of these regimes have produced consistent and clearly articulated guidelines. The argument is no more convincing as a guide to policy than the observation

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[2] For example, section 3.2 equates a small number of competitors with "limited competition" and one-sidedly equates the number of players with collusion or oligopoly.

that "most other countries" protect their agricultural sectors. Paradoxically, the Privy Council did establish a clearly articulated and hard-won guideline in the Clear-Telecom case which the government immediately emasculated by ministerial proclamation. Clear and consistent guidelines are not normally a characteristic of politically determined outcomes.

2.6 The Draft Report's fourth reason is that self-regulation is "unlikely to deliver such outcomes" in the absence of "an effective regulatory backstop". By 'self-regulation', the Draft Report appears to be thinking of an industry forum. There does indeed appear to be no reason to expect competitors in an industry forum to agree on a set of guidelines, unless one set of guidelines makes all producers better off. But users would surely be suspicious of any such set. In short, the conflicts of interest around any table comprising competitors and users are so glaring as to create the risk that such a forum would be either largely ineffectual or highly political, factionalised and divisive, depending on its rules. But the difficulties with self-regulation of the type envisaged do nothing to establish that any "regulatory backstop" can overcome the problems raised in paragraph 2.3.

2.7 The complexities of any commercial negotiations providing for interconnection between diverse and rapidly evolving technologies, and the relatively low salaries that could be paid to any regulators relative to the most talented people in the industry, make it implausible that any regulator could make a well-informed and expeditious decision about the optimal arrangements. No feasible budget could possibly be large enough. In any case, no means has ever been found of providing regulators with the incentive to act solely in the national interest. Regulators cannot be expected to be indifferent about the expectations of their political masters, populist public opinion or their own futures and those of their organisations.

2.8 The faster a regulator is required to make a decision, the more information-limited it is likely to be. Any party to a commercial negotiation is less likely to settle if it judges that the regulator is likely come down on its side as long as it keeps insisting that the other party's offer is unreasonable. Regulators become part of the regulatory game. But their part is characterised by relatively poor information and suspect incentives.

2.9 Industry-specific regulators have an easier life if they enjoy the support of the industry they are regulating. One way they can do this is to permit regulations that set up entry barriers against those outside the regulatory club. This is hard to avoid. For example, all rules must establish boundaries that define who is subject to industry-specific regulations and who is not. The compliance cost of these regulations creates an incentive for those just outside the boundary to find innovative ways of competing while remaining outside. Incumbents can reduce the ability of competitors to compete around the boundaries by persuading the regulator to extend the regulatory boundaries in order to counteract the effects of the emerging competition. The regulator has an obvious incentive to accommodate such complaints.

2.10 The Draft Report does not acknowledge these potential difficulties and concerns. Its failure to do so means that it provides no basis for believing that the benefits from industry-specific regulation are likely to exceed its costs. The worldwide moves by governments towards deregulatory policies over the past 20 years have been motivated by the recognition that while markets may not produce outcomes that are 'perfect' in some ideal sense, regulations in practice often produce worse outcomes. The Draft Report almost totally ignores these lessons.

2.11 We also see serious grounds for concern about the degree to which section 4.5 gives the Commissioner the power to levy any party that they choose to regard as unreasonably obstructive. This readily abusable power is in addition to the proposal in the Draft Report's section 4.4 that would deny aggrieved parties any appeal rights in respect of the Commissioner's final determinations. Far from being impartial and apolitical, the Commissioner will be a player in a complex political and commercial regulatory game. It is evident from the Draft Report that the relationship between the Commissioner, the minister and other regulatory bodies and government agencies is open for debate. There is no reason to believe that any initial decisions about the allocation of responsibilities will stand. To the contrary, each agency can be expected to struggle to defend and expand their own patch. We question the constitutionality of giving any regulatory agent powers that are so wide and so far removed from the scrutiny of parliament.

2.12 In our view New Zealand was right to eschew the option of an industry-specific regulator when Telecom was privatised – on a balancing of the possible advantages and disadvantages. Now that Telecom is exposed to serious competition on all fronts, the case against an industry-specific regulator seems far more clear-cut. The recent inquiry into the electricity industry, an industry that is less dynamic and apparently less contestable in parts than telecommunications, rejected calls for an industry-specific regulator. The problems with such approaches to regulation in other countries and industries should be recognised by the Inquiry.

2.13 The Draft Report asserts on page 12 that its authors have sought to constrain regulatory creep and to keep regulation focused and to the necessary minimum, with each regulation being "tested on its merits". In contrast to these sentiments, the Draft Report makes no such evaluation of its major proposals. It is riddled with the view that issues should be decided on the basis of consensus rather than analysis. Nor does the Draft Report make a recommendation for a firm date for reviewing the case for an industry-specific regulator and the mandatory supply/designated services structure. In our view it should do so if, contrary to our submissions, it maintains its proposals, and it should also specify for such a review the performance measures for which its proposed system should be held accountable.

3 The Draft Report's grounds for intervention

3.1 The Draft Report does not analyse the grounds for government intervention in telecommunications. Commendably, its authors do not make the all too common presumption that the industry is a natural monopoly. Nor do they argue that there are any significant parts of Telecom's operations that are not subject to competition. – the finding in this respect in relation to the local loop is important and overdue. We are not aware of anyone now making the claim that was being made only a year ago that mobile cannot compete with the local loop for data or that Saturn will not roll out cable beyond Wellington.

3.2 Instead the Draft Report advocates intensive industry-specific regulation of telecommunications on the grounds of dominance, imbalances in market

power and essentiality.[3] Dominance appears to be assessed on the basis of the number of competitors (ie counting heads) rather than on the potential for entry in the event of monopoly pricing.

3.3 On this view, it could be bad for a firm to obtain a dominant position by providing better value for money for customers than its competitors. This is because a large market share means dominance and an imbalance of bargaining power. It might also be bad to be the first to bring a new technology to New Zealand successfully. This is because being first provides the original entrepreneur with an unfair 'first-mover' advantage.[4]

3.4 This approach also ignores the possibility that the small size of the New Zealand market in relation to the optimal scale might mean that consumers' best interests are served by a relatively small number of competitors. In their book on Microsoft's global market share, Liebowitz and Margolis have postulated that the gains from a standardised operating platform may be such that the market structure that maximises consumer welfare is one in which there is a sequence of dominant suppliers through time.[5] Competition is manifested by the replacement of one dominant supplier by another rather than by the elimination of dominance. Microsoft has, for example, displaced IBM as the dominant player in parts of the industry. Dominance is achieved by providing better value for money than one's competitors and reaping any economies of scale that come with an increasing market share. Sooner or later a new, more nimble competitor with a new technology or product is likely to enter and repeat the cycle. The Draft Report does not envisage such a possibility.

3.5 A telling feature of dominance achieved in a competitive and dynamic environment is the downward trend in prices to consumers while quality is increasing. This feature is evident in computing and in telecommunications. The complexities of competition in periods of rapid technological change, when large market shares can be quickly undermined and created, make regulation particularly hazardous.

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[3] Refer, for example, to page 13.

[4] Refer to page 54 for a claim that the first-mover allegedly has an unfair advantage.

3.6 The Draft Report's failure to analyse the state of competition in the telecommunications industry is, in our view, a serious shortcoming. This omission leads the Inquiry to propose a system where dominance alone provides a rationale for heavy-handed regulation of prices. Reputable academics who have analysed the performance of New Zealand's system of regulation have concluded that it has performed well in important respects compared with the sort of system that the Inquiry team now proposes for New Zealand.[6] If the Inquiry team is unable to provide a cogent basis for ignoring such findings it invites the presumption that its approach is simply driven by an anti-market ideology and interest group capture. In our view it owes New Zealanders a duty to analyse public policy issues seriously. If it lacks the time and resources to do so it should say so and be more circumspect about its conclusions.

3.7 Why does the Draft Report focus so little on the level of consumer welfare – assessed, for example, by reviewing entry barriers, price trends and the level of prices relative to marginal cost? One clue is provided by the opening sentence in section 3.6 that states that "the ideal outcome for electronic communications is a highly competitive sector". Add to this the only half-true notion that the level of competition can be assessed by counting the number of competitors and the question answers itself.

3.8 Two related issues that the Draft Report arguably does not treat with sufficient care are the importance of the profit motive and the distinction between the stimulus to innovation globally and the spread of those new technologies to New Zealand. Consider, for example, the following sentences from page 8 of the Draft Report:

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5 Stan Liebowitz and Stephen Margolis, *Winners, Losers & Microsoft*, The Independent Institute, 1999.

6 Refer, for example, to: David Boles de Boer, Christina Enright, and Lewis Evans, "The Internet Service Provider (ISP) Markets of Australia and New Zealand", New Zealand Institute for the Study of Competition and Regulation, May 2000; Henry Ergas, "Telecommunications Across the Tasman: A Comparison of Regulatory Approaches and Economic Outcomes in Australia and New Zealand", 1996; David Boles de Boer and Lewis Evans, "Government Department to Public Corporation in a Deregulated Economy: The Economic Efficiency of New Zealand Telecommunications", 1994; and Pablo Spiller and Carlo Cardilli, "The Frontier of Telecommunications Deregulation: Small Countries Leading the Pack", in *Regulators' Revenge: The Future of Telecommunications Deregulation*, edited by Tom Bell and Solveig Singleton, Cato Institute, 1998.

> Many expert commentators assert that the uptake of information and communications technologies is likely to be greatest in an electronic communications market that is highly competitive and efficient. Under such conditions, providers (both existing and new entrants) will have incentives to invest in new infrastructure (including network capacity), new technologies and new products.

In conjunction with the view that the level of competition can be determined by counting heads, these sentences embody the idea that an industry dominated by one or two players will fail to bring new technologies to New Zealand expeditiously. This proposition is misleading. Economists would normally presume that monopolists and perfect competitors have the same objective – profit maximisation. If this were all there were to it then both groups would bring new technologies to New Zealand as soon as it was profitable to do so.

3.9 To make a case that a hypothetical monopolist or oligopolist would be undesirably slow to bring new technologies to New Zealand, some additional assumptions must be introduced. One might be that the monopolist is government-owned or is a non-profit, so that normal profit incentives do not apply. Neither assumption applies to Telecom or Vodafone (although TVNZ is another matter). Another possibility is that the monopolist (or the industry) is subject to a form of regulation (eg profit control) that impairs the profit motive. (Industry-specific regulation seems likely to impair the profit motive and dynamic efficiency, but that is not what the authors of the Draft Report can have had in mind when they wrote the above sentences.)

3.10 Against these negative possibilities is the Schumpeterian argument that it is the hope of being able to achieve and retain monopoly profits that spurs firms to take significant risks. Obviously, those who take the risk of being first to introduce a new technology to New Zealand start at the bottom of the learning curve. First movers allow all competitors to learn from their mistakes.

3.11 The authors cite no authorities in support of the sentences quoted in paragraph 3.8. Of course, no reputable economist would deny that competition spurs innovation. But it is the profit motive that drives businesses to seek ways of overcoming the entry barriers that protect competitors' markets while creating barriers that protect their own profits. Regulations that

artificially lower entry barriers reduce the incentive to find innovative, market-driven ways of overcoming them and to make investments that would create competitive advantages in the first place.

3.12 The key problem here is that the Draft Report overlooks the critical importance of the profit motive and properly scaled entry barriers to innovation (it is well-established in economics that the 'right' level of entry barrier is not an artificially low one). By interpreting competition as a matter of counting heads, the Inquiry is likely to achieve the opposite of what it desires.

4 Mandated services

4.1 A key thrust of the Draft Report is to mandate access to 'designated services'. Analyses of conventional monopoly problems produce no such recommendation. The conventional monopoly problem arises because the monopolist will not supply at a price that is equal to marginal cost. The issue is price, not willingness to supply.

4.2 To make a case for forced supply, the Draft Report had to introduce issues that do not arise in the conventional analysis of monopoly. It is far from obvious why it is in the public interest to force a private profit-maximising firm to supply anything. Such firms owe it to their shareholders to maximise profits by legitimate means. To refuse to supply at a profitable price is to reduce shareholder wealth. Similarly, to force supply when marginal benefit is less than marginal cost may well reduce welfare.

4.3 The Draft Report rests its case for mandating supply partly on the argument that 'any-to-any' connectivity is essential in telecommunications. But this does not establish any grounds for believing that a profit-maximising monopolist would fail to permit interconnection at a profitable price. In a commercial setting the issue is inevitably price. In the extreme, one party can resolve any disagreement about price by simply buying the other's company (if takeover laws do not prohibit this option or make it too costly).

4.4 What then is the Draft Report's case for mandating supply? In the following paragraphs we consider three possibilities.

4.5 Dire necessity is one possible rationale for mandating supply. Under the common law it is accepted that in an urgent life or death situation someone may dock their vessel in someone else's vacant berth without their permission – as long as they compensate the rightful owner for any losses after the event. In effect, the rightful owner has been lawfully forced to supply a berth. But no issue of urgent dire necessity applies in respect of telecommunications.

4.6 Hold-out provides a second possible rationale. It is possible that some individual may idiosyncratically, if not maliciously, refuse to take an action that would cost very little but would provide the only means of conferring much greater benefits on the public at large. For example, suppose one hair from one person's head provides the only means of finding a cure that could save the lives of millions. Only an extreme individualist would deny that forced supply may be justifiable as a *last* resort. But, as discussed, there is no reason to expect that a large, reputable, profit-maximising firm would turn down profitable opportunities to supply. The real issue in such cases is the level of profits, not the willingness to supply.

4.7 The Draft Report points to a third possible reason for mandating supply. It is the notion that suppliers have to be forced to supply because it is socially desirable for them to supply at a loss. One hint that points to this argument appears on page 9 of the report where the Inquiry states how it interprets the government's objective of delivering services on a 'fair and equitable' basis. The relevant section reads as follows:

> The Inquiry takes this to mean ensuring that all existing and potential users have affordable access to a minimum level and standard of services. It also includes ensuring all sectors of the community can fully participate in the information economy.

Much more explicitly, the Draft Report expresses the view on page 47 that:

> Without [USO] obligations, some services in some areas could be compromised or not provided, because they may not be sufficiently profitable in a purely commercial environment.

4.8 We expressed our opposition to the Inquiry's interpretation of the government's objective in our earlier submission. We argued that at the very

least the Inquiry should clearly identify what effect equity considerations were having on its recommendations by identifying what it would recommend if efficiency were the sole consideration. Instead of accepting or addressing our arguments on this point, the Draft Report resorts to counting heads on the issue.[7] We suggest that the upshot is that the Draft Report's submissions are an inchoate mixture of efficiency and equity considerations. Why it might be equitable for the poor in the cities to cross-subsidise access for asset-rich farmers in remote regions is something that the Draft Report does not discuss. Nor does it consider why telecommunications services to remote consumers should be under-priced while the same consumers pay the full economic costs of roading services, electricity, food and practically everything else they consume.

4.9 Mandatory supply is an element of Telecom's Kiwi Share obligations. But these obligations were imposed in respect of an existing infrastructure. They were also a known condition of sale to the purchasers. Arguably they were justifiable at the time as a means of easing consumer uncertainties about price movements in the transition to the much more competitive market that prevails today.

4.10 Furthermore, the imposition of such a requirement has no effect on the existing infrastructure. However, it is likely to have an adverse effect on willingness to invest further in this infrastructure. The sharp growth in demand for line capacity must surely make this more of an issue than it was at the time the Kiwi Share was created. If so, the potential cost to dynamic efficiency of the Kiwi Share restrictions is increasing.

4.11 Imposing a requirement of mandatory supply to competitors is of even greater concern. This is because there is a risk that such a requirement could undesirably inhibit investment in competing networks. An incumbent has an incentive to connect competitors where it is profitable for it to do so. This is likely to be where the competitor can perform the service more cheaply than the incumbent. If it refuses to do so it takes a risk that the efficient competitor

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[7] On page 9 the Draft Report blandly states that "nearly all submissions either generally supported the Inquiry's interpretation of the Government's objective or were silent on the issue". This evades the substantative point.

will overcome the problem by bypassing even more of the incumbent's network. Mandating access to a network will reduce entrepreneurial efforts to discover substitute means of meeting consumers' needs and reduce dynamic efficiency. Those points apply not just to 'old' technologies but to new developments such as cellular transmission sites and roaming facilities.

4.12 A further concern is that such a provision makes the incumbent vulnerable to gaming. Whereas the incumbent has irreversibly committed to constructing infrastructure, the would-be competitor may be able to hold back from investing pending a favourable regulatory decision. The incumbent subject to mandatory supply has no such ability. This creates lop-sided risks for anyone planning to invest in such a facility. One option that might make this game less one-sided would be a requirement that any competitor asking for a price determination in relation to an incumbent provides a legally binding commitment to undertake a proposed investment programme regardless of the outcome of the price determination process.

4.13 A further threat to dynamic efficiency arises because of the costs to an incumbent of having to cater for the demand for capacity from competitors as well as from its own customers. Competitors have sound reasons for being less than frank about their likely demand for capacity. To illustrate the problems, suppose that a capacity constraint arises because a competitor's facilities fail unexpectedly. A requirement of mandatory non-discriminatory supply might mean that the incumbent must inconvenience its own customers in order to increase the capacity available to competitors. Unless the competitors are compensating the incumbent for such an insurance policy, this seems bound to deter new investment by the incumbent.

4.14 For these reasons we have major reservations about the Draft Report's recommendations for mandatory supply. Such rules must surely deter investment in the facilities that are so designated. The costs can be expected to be heaviest in the more capital intensive of those facilities and where demand is growing fast and technologies are rapidly changing. Such regulation seems to be particularly ill-suited to the telecommunications sector as it exists today.

4.15 In our view the Inquiry team should take very seriously Vodafone's warning at a recent TUANZ conference about the negative implications for investment of the proposal for mandatory roaming. However, the warning applies to all the Draft Report's proposals for mandatory access.

4.16 We cannot understand how the Draft Report can stress the importance of dynamic efficiency while making recommendations that are highly inimical to that goal. The Inquiry's thinking is surely already having a negative effect on planned investments in activities that may be subsequently deemed to be designated.

4.17 Market economies depend for their efficiency on well-defined and well-enforced property rights. Regulations that deprive those who invest in infrastructure of property rights to that infrastructure violate core principles of individual liberty and undermine dynamic efficiency. The equity of regulations that are implemented at the behest of who stand to gain at the expense of those who have invested in those assets in good faith is also suspect. In our view the Inquiry must accept the burden of proof that the benefits of its proposals exceed the costs to such an extent that the violation of such fundamental principles is warranted.

5 Designated electronic services

5.1 Section 6 of the Draft Report contains proposed obligations for providers of designated services and proposed criteria for adding or removing designations. Views about such criteria should be based on a coherent analysis of the rationale for such designations.

5.2 Our analysis above failed to find an efficiency rationale for making supply mandatory. If the Inquiry team has an efficiency rationale it should identify it in its final report. Furthermore, we also failed to find an equity rationale for such an interpretation that would obviously accord with conventional equity notions such as the idea that if governments are to transfer wealth it should be from the well off to the less well off rather than the other way round.

5.3 The Draft Report's proposed list of mandatory obligations look like a new entrant's rent-seeking dream. All the obligations fall on the entities that are likely to have made the biggest investments and taken the biggest risks in developing the market successfully. No obligations are placed on a possibly opportunistic new entrant. No evidence needs to be provided that the incumbent was behaving uncompetitively before designation occurs. Success itself in the form of a high market share may suffice.

5.4 The Draft Report's proposed criteria in section 6.2 for adding or removing designations are, as the Report notes, "largely based on equivalent Australian provisions". The Draft Report makes no reference to a recent study of the Australian provisions that finds that this set of tests is inappropriate and should be revised.[8]

5.5 In our view the proposed tests lend themselves to the following erroneous interpretations:

- facilitating the entry of more competitors enhances efficiency;
- promoting 'efficient' 'any-to-any' connectivity is better than promoting other 'efficient' activities; and
- encouraging greater use of existing infrastructure promotes efficiency.

5.6 The fundamental problem here is that any decisions taken in respect of these criteria could undermine dynamic efficiency, as reflected in the willingness to invest further in designated services or in facilities that might become designated services.

5.7 We have absolutely no confidence that in practice any regulator is likely to avoid these errors. Mandating supply after private sector entities have invested in facilities is clearly a regulatory taking. It should not be permissible, particularly in the absence of any proof of the abuse of a dominant position or of any assessment of the welfare costs of the proposed

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[8] Daley, Anne and Stoeckl, Natalie, "Declaration of Telecommunication Services", *Agenda*, Volume 7, No 2, 2000, pp 113-124.

regulations. If it is done, compensation should be payable. The Inquiry team does not consider this point.

5.8 On the other hand, mandating supply in advance of the investment would appear to provide a significant deterrent to the sort of investment in facilities to which the Inquiry team obviously thinks it is essential for New Zealanders to have access. Since the government cannot force telecommunications companies to invest in New Zealand, the Inquiry team cannot both ensure access and not deter investment. We find it difficult to draw any conclusion other than that New Zealand should allow all entities to have full property rights in their investments as long as they comply with existing laws of the land, including the Commerce Act. Mandating supply of capacity to competitors looks like a major mistake.

5.9 In the time available we have not explored the possibility of making mandatory supply a remedy for proven serious breaches of the Commerce Act. However, even here there is a problem in that the regulator might inadvertently dictate a price for supply that fell below marginal cost.

6 Pricing principles

6.1 Section 7.1.3 of the Draft Report presents the Inquiry's assessment of the pricing principles that might be applied to the regulation of interconnection agreements. It expresses the view that 'bill and keep' provides the most desirable approach to interconnection where appropriate. This begs the question as to when it would be appropriate. Where bill and keep is not appropriate, the Draft Report favours pricing at TSLRIC (total service long-run incremental cost), although it notes that this approach is highly model- and assumption-dependent, making any results contentious. Reflecting on this difficulty, the Inquiry sees "considerable merit in a benchmarking [or read-across] approach" based on interconnection prices in other markets. However, it acknowledges that such an approach would give rise to a range of prices that would need to be adjusted to accommodate New Zealand-specific factors. The Draft Report concludes that its proposed regulatory Commissioner should use a benchmarking approach to determine a range of prices to prevail for at

most one or two years and that within this range "the correct positioning" would be the Commissioner's best estimate of where New Zealand would fall if a full TSLRIC assessment were undertaken.

6.2 This discussion amply illustrates the wide discretion that the Draft Report desires to confer on the Commissioner. Independent world-class experts could not be expected to agree on where costs would fall under a full TSLRIC assessment for any industry.[9] This is because such assessments must make assumptions about future technologies and future costs that are inherently entrepreneurial. The Commissioner will not be competent to evaluate disputes between experts and will not be independent as they will not be indifferent to the effect of any decisions on their own role. In any case, neither the views of experts nor regulators should carry the day. The market provides the most rigorous forum for testing competing views about the future. It is the only forum that requires those with competing views to back them with their own money. Putting one's own money on the line focuses the mind and provides a discipline that is not present in academic, political or bureaucratic assessments of future demand and future costs.

6.3 The Draft Report proposes to replace an imperfect system of price discovery subject to market disciplines by a system in which a regulatory bureaucrat will have wide discretion to set prices according to bureaucratic objectives, perhaps using bill and keep, benchmarking or largely unverifiable assertions about TSLRIC along the way. The asymmetry in the Draft Report's approach to light-handed regulation and heavy-handed regulation is striking. The former is rejected in part because it allegedly has not produced a clearly articulated set of pricing principles. However, the Draft Report's alternative arrangement for setting prices fails to solve this alleged problem.

6.4 The Draft Report fails entirely to discuss the threat its pricing proposal poses to dynamic efficiency. What assurance can a dominant incumbent have that the proposed system will offer a reasonable chance of recovering the costs of a major investment whose time horizon is longer than the proposed one or two years?

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9 See Henry Ergas, "TSLRIC, TELRIC and Other Forms of Forward-Looking Cost Models in Telecommunications: A Curmudgeon's Guide", mimeo, November 1998.

7 Industry forum

7.1 In our view the proposal to create an industry forum with legislative backing is fraught with risk. The parties to the forum will have a high degree of self-interest and any decisions coming out of it could well reflect the interests of a dominant coalition rather than the national interest. If this happens and the decisions make a difference, the forum could well become a very divisive, politicised and controversial body.

7.2 We are also sceptical that any such Forum could agree on codes of practice for designated services given the conflicts of interest and the technical difficulties of this task. We doubt whether even a representative group of independent economists could come to such an agreement. The task seems naï ve and utopian. Conflicts of interest are an absolutely routine feature of the commercial world. They are best resolved in the marketplace.

7.3 If nonetheless such a Forum is established, in our view its decisions should be made only on an unanimous basis. This risks paralysis, but it avoids the inequities and inefficiencies that would result from the gaming that must otherwise be expected. For the same reasons, its range of functions should be minimised.

8 The Kiwi Share and universal service obligations

8.1 Section 9 of the Draft Report discusses the issue of access to electronic information services. We are pleased that there is now a widespread view, reflected in part in the Draft Report, that the Kiwi Share is the source of significant problems in the industry. We have long argued that its costs appear to outweigh any benefits and expressed this view in our earlier submission to the Inquiry.

8.2 We fully support the Draft Report's recommendation that the requirement that line rentals be no higher for rural users be removed from the Kiwi Share's requirements, on the presumption that this proposal is acceptable to both parties to the Kiwi Share contract.

8.3 However, we strongly oppose the Draft Report's recommendation that other elements should be retained in an expanded form to accommodate the increased demand for lines for data purposes.

8.4 We also strongly oppose the notion that the Kiwi Share should be amended unilaterally by the government, without compensation, on an ongoing basis. The Kiwi Share is in effect a contract. Amendments to its terms should be a matter for the parties to the contract to negotiate. We note on page 46 that the Inquiry expresses the view that the cost of the Kiwi Share should lie with Telecom. If the Inquiry bases this view on a presumption of contractual integrity, it should take the same approach to proposals to change the terms of that contract.

8.5 In our view there is a strong public policy case for the government to determine that it is no longer in the public interest to preserve the restrictions embodied in the Kiwi Share contract, including the requirement to provide a free local calling option. The transition from a statutory government monopoly is over. Competition is manifest. The restrictions are distorting competition undesirably and generating hidden wealth transfers that are not being properly scrutinised by parliament. They could well see unsophisticated, low-income consumers heavily subsidising technologically proficient users of the Internet from well-off households. The Inquiry team has failed to analyse the equity implications of its recommendations – even those that are driven by equity considerations.

8.6 We can only urge, once again, that the Inquiry clearly separates its analysis of efficiency issues from its analysis of equity issues. To fail to do so makes it all too likely that its final recommendations will serve neither objective well.

9 Information disclosure

9.1 Section 8 of the Draft Report discusses the issue of mandatory information disclosure and recommends that all existing information requirements should be repealed. We applaud its recognition of the costs of these requirements and of the need to ensure that any benefits are commensurate with those costs. We

also applaud its recognition of the point that current and future costs are more important for many purposes than past costs.

9.2 We argued against mandatory disclosure in submissions to government agencies in the past, but to no avail.[10] The Inquiry's finding that the disclosure regulations are unsatisfactory so soon after they were reconsidered and expanded should be seen as a salutary lesson in the pitfalls of regulatory policy making. As a regulatory agency the Ministry of Commerce (now the Ministry of Economic Development) has shown all the impulses towards expanding regulation that we postulated earlier in this submission in relation to a industry regulator. The experience with disclosure should serve as a warning in considering other impulses for regulation.

10 Information society initiative

10.1 Section 9.3.1 of the Draft Report requests those making submissions to indicate if they would favour the establishment of an industry-funded body to "facilitate participation in the information economy by all New Zealanders". In our view the priority in this area must be to examine the reasons why such a large proportion of New Zealanders have not achieved the level of literacy that international experts regard as necessary for normal day-to-day living. Given the extensive government ownership, funding and regulation of education, this is a governmental responsibility. No industry body can do more than scratch the surface of this job. One should not be created and charged with this responsibility.

10.2 Membership of any Forum should also be voluntary and its decisions should not be binding on those who are not members. Funding should be a matter for the members to determine for themselves.

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[10] See, for example, "Submission on the Ministry of Commerce's Telecommunications Information Disclosure Discussion Paper", New Zealand Business Roundtable, December 1998.

11 Spectrum allocation and management

11.1 Section 10 of the Draft Report epitomises the Inquiry's unsound focus on counting competing heads rather than assessing proposals on the basis of consumer welfare criteria. It proposes a number of ways of taxing Telecom and Vodafone in order to speed up the entry of competitors. This is likely to inhibit investment by Telecom and Vodafone and be followed by measures to protect the viability of the new entrants whose presence has been achieved by such artificial means.

11.2 We simply cannot comprehend how the Inquiry team can form the view that "strong competition in the 3G band is vital to the future of telecommunications in New Zealand". Telecommunications in New Zealand will have a future regardless of the number of competitors exploiting the 3G band as long as the profit motive is alive and well. If there is a choice between having the 3G band exploited by one dominant party or not at all, why would consumers prefer the latter option? The risk that ill-conceived regulation will adversely affect the timing and quantum of investment in such technologies should be taken seriously.