NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE MINISTERIAL INQUIRY INTO TELECOMMUNICATIONS' ISSUES PAPER

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Summary

- This submission on the Ministerial Inquiry (the Inquiry) into Telecommunications' Issues paper (the Issues paper) is made by the New Zealand Business Roundtable (NZBR), an organisation consisting primarily 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.

- In section 2 of this submission we argue strongly against the Inquiry's interpretation of the government's objective for the telecommunications industry. In our view it is not consistent with the objective of achieving a dynamic, competitive and efficient industry. We believe that it is highly undesirable to try to use the industry as a means of redistributing income.

- In section 3 we argue that the community would be better off if the Kiwi share restrictions were abolished. We also recommend explicit subsidies, subject to parliamentary scrutiny, rather than the imposition of any alternative form of universal service obligation.

- In section 4 we explain why we see greater risks to the community from the undesired and unintended effects of regulations on investment decisions than we do from the possible exploitation of any remaining elements of market power in the industry. Particularly given the dynamic nature of the industry, policy makers should not put concerns about allocative efficiency ahead of concerns about dynamic efficiency. This is why we continue to favour the light-handed approach to regulation of this industry, based upon a generic Commerce Act.

- In section 5 we address some of the Issues paper's specific questions in detail and indicate the implications of our thinking for the range of questions more generally. In our view far too many questions invite respondents to state where they see a *need* for further regulation – rather than to state what they

consider to be the likely benefits *and* costs of further regulation. This format seems likely to bias responses in favour of further regulation.

- What counts for a sound outcome of the Inquiry is the quality of the analysis, not the number of submissions expressing any particular view. We strongly urge the Inquiry to base its recommendations on rigorous analyses of *all* the likely material effects (desired or undesired) of the regulatory proposals it wishes to consider.

1 Introduction

1.1 This submission on the Ministerial Inquiry (the Inquiry) into Telecommunications' Issues paper (the Issues paper) is made by the New Zealand Business Roundtable (NZBR), an organisation consisting primarily 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 Ministerial Inquiry is required to examine regulatory arrangements for the New Zealand telecommunications sector in order to ensure that the regulatory environment meets the government's objective of "achieving cost efficient, timely, and innovative telecommunication services on an ongoing, fair and equitable basis to all existing and potential users". The Issues paper raises 55 questions covering a wide range of topics.

1.3 The NZBR has a longstanding interest in the public policy issues associated with the regulation of telecommunications networks. In our July 1998 paper *Regulation of Network Industries: The Case of Telecommunications* we questioned the common assertion that local loops are a natural monopoly. We also questioned 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 supported New Zealand's approach of (at most) light-handed regulation of network industries. This does not mean that we have not been prepared to consider the desirability of modifications to existing arrangements where warranted. To the contrary, we have expressed concern about the risks of counterproductive effects from the Kiwi share requirements and the disclosure requirements embodied in section 5 of the Telecommunications Act 1987.

1.5 This submission primarily focuses on the issue of whether the government's objectives can be best achieved by continuing with light-handed regulation. By this we mean the absence of price control, price regulation (such as CPI-X),

rate of return regulation, or an industry-specific regulator. Section 2 discusses the Inquiry's interpretation of the government's objective for the industry. Section 3 discusses the Kiwi share and the issue of participation in the information economy. Section 4 discusses the issue of light-handed regulation. Section 5 relates these responses and this approach to the questions posed by the Inquiry in the Issues paper.

2 The government's objective

2.1 The government states its objective for the industry in the terms of reference for the Inquiry as follows:

> The Government's objective for telecommunications is to ensure that the regulatory environment delivers cost efficient, timely, and innovative telecommunication services on an ongoing, fair and equitable basis to all existing and potential users.

2.2 In the NZBR's view, this objective statement could and should be interpreted as saying that the government seeks an economically efficient industry. As long as prices are set competitively, whether it be for food, clothing or houses, it is overwhelmingly accepted amongst consumers and voters that market prices are generally fair and equitable to all existing and potential users.

2.3 This is not in any way to claim that market prices are perfectly equitable. Where existing prices of necessity represent an averaging of costs across diverse customers, their effect might be to overcharge one group for the benefit of another. But innovative competitors will seek means of 'cream-skimming' the group being overcharged. If they are successful such 'inequities' will be eliminated. If they are unsuccessful, the differentials are likely to be accepted as an irremovable 'fact of life'. For example, most accept that it is inefficient to try to charge cyclists for their use of the roads, whereas motorists pay petrol tax and may one day pay congestion charges. In these cases existing arrangements may still be regarded as equitable in the

circumstances because they reflect pragmatic necessity rather than wilful discriminatory intent.

2.4 Under our suggested interpretation, the prices set in an industry subject to monopoly regulation could also be regarded as fair and equitable as long as they were economically efficient. However, they might be regarded as inequitable if they allowed some users to cross-subsidise others even though existing billing technologies would allow those cross-subsidies to be economically eliminated.

2.5 In contrast, the Inquiry puts a contentious interpretation on the government's objective for the industry. On page 7 the Issues paper states that:

> The Inquiry takes this [the words "a fair and equitable basis"] to mean ensuring that all existing and potential users have affordable access to a minimum level and standard of telecommunications services. It also includes ensuring all sectors of the community can fully participate in the information economy. In achieving this, an important consideration is how the cost associated with meeting this objective is met, and by whom.

2.6 This interpretation is contentious because it introduces the concept of "affordable access to a minimum level and standard". This confuses income with price. This interpretation draws the Inquiry into the issues of the adequacy of incomes and the welfare system. What is affordable obviously depends on the level of market and non-market income as well as the price of the product. At this point, the issue is not whether the price is competitive or monopolistic. Rather, it is whether the price is 'too high' in relation to someone's income. But a system that links prices to income adequacy will lead to inefficient pricing and investment decisions.

2.7 The Inquiry's interpretation is also contentious because it appears to elevate, by fiat, telecommunications to the 'essential' status associated with food, clothing and shelter. Logically, if access is to be affordable to people with no spare income, it must be free to the user. Free access transfers to the

government the problem of organising and rationing supply. Any judgment about the minimum level and standard of service that must be 'affordable' is a political decision. It follows that investment and pricing decisions will be politicised. Dynamic and allocative efficiency would be forgone. Moreover, the equity of the policy would also be in doubt if the least well off also lacked the education, skill and motivation to participate in the subsidised services as much as better-off groups.

2.8 We do not believe that the Inquiry has the jurisdiction, competence or resources to solve fundamental problems of income adequacy. In our view the Inquiry will have failed if it does not take seriously the problem of determining what forms of regulation are likely to best promote economic efficiency in this industry. We would have no quarrel if it then explores the question of whether modifications to such regulations might be warranted on other grounds. Such a two-step process would make the effects of the Inquiry's value judgments in relation to non-efficiency aspects transparent.

2.9 There has been a solid consensus amongst professional policy analysts in New Zealand for over 15 years that concerns about income adequacy are best addressed in a broad manner through the tax and transfer system rather than by attempts to manipulate the prices of goods and services produced by particular industries. In our view there are eminently sound reasons for this consensus. We do not believe that the Inquiry's findings will carry enduring weight with serious policy analysts if they are simply seen to reflect an *ad hoc*, arbitrary and inscrutable trade-off between efficiency and conflicting notions of equity and income support.

3 The Kiwi share and participation in the information economy

3.1 Sections 2.3 and 2.6 of the Issues paper raise the issue of participation in the information economy and the role of the Kiwi share. Section 3.4.1 discusses the Kiwi share issue specifically. Section 4.6 discusses current universal service obligations.

3.2 The NZBR does not believe that the Kiwi share restrictions do "facilitate the ongoing delivery of Internet access and other telecommunication services critical to the development of an information economy" to the maximum possible extent. In our view the strongest argument for these restrictions at the time was that they were necessary in order to ease concerns about residential and rural line charges for telephony during the transition to a privately owned competitive industry. The objective of easing the transition has now been achieved. The Issues paper itself comments on page 23 that "In practice, however, the line rental charged by Telecom has consistently been held below this [CPI-related] ceiling."

3.3 It was well recognised at the time that such restrictions could impair the development of the industry by distorting investment decisions. The Issues paper recognises these distortions in sections 4.6.1 and 4.6.3. However, in section 4.6.4 it asserts that "the quality of the local loop in rural areas, and how it might be improved, is central to the debate over the future of the Kiwi Share". The paper discusses two options: explicit subsidies for the universal service obligation, or a competitive tender of some services.

3.4 Providers who are forced to cross-subsidise services to rural or other customers will be likely to under-invest in services that it would otherwise be economic to provide on an unsubsidised basis. Providers do not have to invest in New Zealand and some of the investments required in this industry are major. It is undesirable to force only the incumbent to provide cross-subsidised services since this will invite new entrants to invest in servicing unsubsidised customers even if these investments are uneconomic from a national perspective. On the other hand even the suggestion that new entrants that wish to develop fixed line or mobile networks might be made subject to the Kiwi share restrictions is a threat to those investments.

3.5 In the NZBR's view the Issues paper is wrong to assume that the interests of rural users in preserving the Kiwi share should be put ahead of the interests of New Zealanders at large. Such treatment would be discriminatory and distort resource use. We also question why the Inquiry assumes that rural communities would prefer subsidies for access to the Internet ahead of better

schools, roads or hospital services, or lower taxes. Certainly, it defies all belief that rural people would be unanimous about such choices.

3.6 It is beyond dispute that bringing high-speed communication services to customers is a costly business. The real problem in bringing services to rural customers, if there is one, is inadequate willingness to pay given the cost of supply. The same problem affects the timing of decisions to invest in urban residential and business services. If costly technologies are desirable, it is hard to see the case for limiting subsidies to rural services. Such subsidies would bear no relationship to incomes and score poorly on any criteria of fairness.

3.7 If the government does, nonetheless, desire to subsidise the supply of Internet services to rural communities, then in our view it should do so explicitly so that the subsidies are transparent and subject to parliamentary scrutiny and approval. This favours the explicit subsidy option raised in the Issues paper on page 24.

3.8 Putting the case for rural subsidies aside, we have also considered the general case for continuing with the Kiwi share. Fortunately, there appears to be widespread agreement (at last) that the existing local loop is not a natural monopoly. It faces competition from both wireless and lines. The Kiwi share is a concern in this context for a number of reasons. One is that it implicitly sanctions cost-plus, CPI-related pricing in local lines. A second is that it creates pressures for regulatory creep that could deter competitive investments in lines. A third is that its existence complicates discussions about interconnection agreements because it creates disputes as to who should bear the cost of meeting universal service obligations.

3.9 For such reasons we strongly believe that the interests of consumers at large would be best served if the Kiwi share constraints and the universal service obligations were removed.

4 Other regulatory issues

4.1 Key features of this industry include convergence, rapid technological change, the need to keep improving capacity in the face of enormous demand growth and intense competition. Full efficiency requires allocative, productive and dynamic efficiency. Antitrust policies are fundamentally motivated by concern with allocative efficiency – ie monopoly pricing. Even in the most static industry there is a risk that regulations that are designed to produce allocative efficiencies will reduce overall efficiency by creating a cost-plus environment. The more dynamic an industry the greater is the risk that regulations might also reduce overall efficiency by distorting investment decisions.

4.2 We are aware of the argument that competitive entry in a network will be faster the lower the price at which the incumbent is forced to supply network services to competitors. However, consumer welfare is not maximised in present value terms by action to maximise entry and minimise prices in the short term. Such a policy can only make network operators more reluctant to invest in their networks in future. As the very existence of the patent system for new ideas acknowledges, it is desirable to protect an incumbent's property. Furthermore, allocative efficiency is reduced if prices are too low, just as it is reduced if prices are too high. Another risk is that when regulations have been used to entice entry those responsible for promoting them will be reluctant to allow the new entrants to fail. To avoid this embarrassment they might allow the regulations to evolve so as to protect entrants against later potential competitors. We strongly caution against allowing regulators to pursue the goal of actively promoting competition – in the sense of simply increasing the number of industry participants – for these reasons. Public policy should focus on the issue of monopoly pricing. A misconceived policy could even reduce competition by removing the prospect of short-term above-normal profits.

4.3 In our view the Inquiry should impose a burden of proof on those proposing heavier regulation of this industry. Proponents should be required to establish that the proposed measures produce net benefits, taking into

account the manifest willingness of competitors to enter and the risks to productive and dynamic efficiency from regulation. We have been concerned for many years about the overly populist nature of much of the agitation for increased regulation of this industry. The following points illustrate our concerns.

4.4 First, the objective of regulation is to maximise the sum of producer and consumer surplus. Lower prices to consumers in conjunction with higher sales are a gain in terms of consumer surplus. But welfare is not increased if lower prices are offset by a greater reduction in producer surplus. All too often advocates of greater regulation use international price comparisons as if producer surplus were an irrelevant consideration.[1]

4.5 Secondly, reported profits reflect the difference between average revenue and average reported cost. At the conceptual level reported profits could be high even in a static competitive equilibrium simply because future marginal costs are higher than average reported cost. For example, a hydro-electric power station may report high profits when it is at full capacity and the cost of additional supply for marginal demand is very expensive. The basic regulatory concern with monopoly is not with profits that reflect economic scarcity but with profits that arise because the price charged for marginal demand exceeds the marginal cost of supply. This cost includes the effect of that demand in bringing forward the time at which additional capacity will be required. In addition, part of the stimulus for research and innovation is the desire to achieve above-normal returns from products that do take off. The high profits that may be earned by successful innovators must be balanced against the losses made by unsuccessful innovators. In the dynamic transition from a cost-plus statutory monopoly to a competitive privatised situation, great gains in consumer surplus can be expected along with increased profits if the incumbent is capably and vigorously managed. The increased consumer surplus results from lower prices and a higher volume of services. Research by Evans and Boles de Boer found that Telecom increased its volume of services on one measure by 35 percent from

1987 to 1993 while reducing its real aggregate network costs by 38.3 percent. Unit prices have generally fallen substantially. Evans and Boles de Boer found that the bulk of the gains accrued to consumers rather to the producer. This is an important finding. All too often Telecom's reported profits are taken as evidence of monopoly pricing (ie holding back on output in order to increase unit prices) rather than as evidence of success in adding economic value. Such superficial attacks on profits *per se* suggest that society would have been better off if Telecom had reduced average network costs by only, say, 25 percent, reduced prices by less and made much smaller profits, handing over a larger market share to competitors. We hope that the Inquiry will strongly resist such facile interpretations of enterprise performance. None of this is to argue that Telecom had no market power, or that someone else could not have done an even better job for its customers and for its shareholders. Rather, our point is that the Inquiry should not treat a firm's achievements in creating economic value for the benefit of its shareholders as well as its customers as a mark against it.

4.6 Thirdly, much is made of the costs and delays of disputes over interconnection, numbering plans and the like. These negotiation costs are very real. But the fact that they are very real tells us nothing about the monopoly issue. There are going to be bilateral bargaining problems in relation to access to any network if the government tells the incumbent that it must provide access to those facilities to competitors at an acceptable price. At that point a competitor has an incentive to discover the lowest acceptable price, not to the incumbent but to the government or the courts. Of course this is not a question that the government and the courts can readily answer. Therefore it is a question that will not go away. Enforced dispute resolution procedures can reduce the negotiation costs but, if the outcomes unduly penalise the incumbent, future investments in such facilities will be undesirably reduced. No proposal for reducing negotiating costs should be considered unless it establishes that the gains in this dimension of efficiency are not outweighted by greater losses in other dimensions. The fundamental

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[1] Section 2 presents some of the reasons for using the tax/benefit system rather than industry policy to redistribute income. There is also the point that changing property rights by fiat subsequent to privatisation raises the issue of compensation.

problem here is intractable: antitrust policy requires that incumbents do not abuse a dominant position, but it rightly allows incumbents to compete vigorously. Because of information costs no one can be sure where the line should be drawn.

4.7 Fourthly, some proponents of greater regulation appear to be unduly pessimistic about the reality of the competitive threat to the local loop from wireless and fibre. The Todd/Clear report, for example, was explicitly dismissive. Only last year the view was still being expressed that mobile technologies would compete with local lines for voice but not data and that Saturn would not roll out fibre in Auckland or Christchurch. The reality is that new technologies are changing costs and opening up new options very rapidly. Competitors can differ markedly in their assessment of the returns from competing investment strategies. Corporate strategies often have a short half-life.

4.8 Fifthly, competitive realities are surely more complex than is commonly envisaged. For example, the conventional wisdom has it that Telecom will be better off the higher the price it can charge for interconnection. However, the higher the price for interconnection, the greater a competitor's incentive to invest in networks that will bypass Telecom's facilities. The incumbent is at risk on both fronts.

4.9 These complexities and imponderables create major problems with heavier-handed regulation of the type that requires a regulator to make ongoing judgments about future costs and prices. CPI-X regulation falls into this category. No amount of information and analysis can provide a reliable estimate of the welfare-maximising value at which X should be set for the next period. Moreover, there is no known practicable manner of inducing a regulator to make an objective assessment of the optimal level of regulation. Any regulator's incentives will be influenced by the incentives affecting those who control the regulator's budget. Since budgets for regulators are inevitably subject to political processes, regulators' decisions have an inescapable political element. This means that interest group pressures and bureaucratic politics can be expected to affect the regulator's behaviour. We

have already commented on the risks that the regulator will adopt a goal of promoting competition in the sense of additional industry players. It may be good politics, but it is not a desirable policy in itself.

4.10 Our longstanding preference is for light-handed regulation. In our view this system, if sustained, offers the best prospects of harnessing the human ingenuity that is required to overcome apparently daunting entry barriers while providing a degree of protection for consumers during the transition from a state-owned statutory monopoly to a privatised, competitive industry. We would be the last to claim that this arrangement is perfect. To the contrary, its only justification is that the attainable alternatives look worse. The costs and delays of litigation and dispute resolution, for example, must be weighed against the large potential welfare losses from inept regulation. In the case of the telecommunications industry competition and bypass are manifest. Far from being characterised by attempts to hold back output by raising prices, the industry is characterised by enormous volume growth, heavy investment requirements and sharp price declines across the broad bundle of services offered. In the absence of harmful regulation, more of the same can be expected for the foreseeable future.

4.11 In our view it is very important that regulators and the regulated resist the incessant pressures to politicise prices and investment decisions in telecommunications. It is highly desirable to keep competitors in this highly competitive and entrepreneurial industry focused on how they can use new technologies to produce increasing benefits for customers. It is economically damaging if they are induced to believe that it is more profitable to lobby governments for privileges and favourable regulation than to focus on cutting costs and bringing new products and services to the market. The CEO of Cypress Semiconductor has recently expressed exactly this concern.[2] Successful lobbying is contagious. The more attention governments give to self-serving lobbying, the more other firms will be forced to join in the game. The importance of innovation and dynamic efficiency and some of the pitfalls of regulation are emphasised in the accompanying NZBR publication

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[2] Rodgers, T J, "Why Silicon Valley Should not Normalise Relations with Washington DC", *Cato Institute*, 2000, pp 1-17.

Telecommunications Regulation based on a seminar with Professor Richard Epstein of the University of Chicago held in Auckland in March 1999.

5. Responses to particular questions

5.1 Questions 1, 6, 7, 30-34. In our view, further deregulation in the form of the abolition of the Kiwi share requirements would improve industry performance. It is hard to see the case for a universal service obligation given the many obvious distortions it introduces. At the very least it should be analysed against the alternative of transparent subsidies that are exposed to direct parliamentary scrutiny.

5.2 Question 2 (section 3). We strongly oppose the Inquiry's approach to the government's objectives for the reasons set out in section 2 above.

5.3 Questions 3 and 4. In our view the experience of other countries with other approaches demonstrates the problems outlined with heavier-handed regulations. The jury may yet be out on the degree to which countries that have induced early entry will be able to resist the temptation to protect the new entrants against subsequent competitors.

5.4 Question 5. Desirable convergence is likely to be impeded if the act of diversifying into another industry brings a previously lightly regulated activity within the umbrella of an inevitably politicised and heavily regulated industry. Convergence should lead to less overall regulation, not more.

5.5 Question 8. The level of entry and investment in facilities and the intensity of the competition are very encouraging. Entry can be expected to be most vigorous where prices are highest in relation to cost. Telecom faces the reality, or threat, of bypass across all the major parts of its system. The higher the price Telecom charges for interconnection, the greater the encouragement it provides to competitors thinking of investing in bypass facilities. Whatever the merits of the arguments about market power in this industry a decade ago, the case for them seems much weaker today. In our

view, regulation poses a greater risk now to efficiency than does market power.

5.6 Question 9. While competitive entry has been a feature of the New Zealand situation, the critical test is not so much the extent of competition (as measured by the number of industry players) but how it has been achieved. In principle, any country can use regulations to actively promote competitive entry and to reduce prices in the short term. But it does not count for welfare if some of this entry is uneconomic, if future investment is deterred, or if the regulatory path leads to future rigidities and inefficiencies. What counts for consumer welfare in the longer term is the quality of the regulatory environment, not the impact effects of regulation.

5.7 Questions 10-29 and 35-55. While we favour light-handed regulation we urge the Inquiry to treat all these issues as a matter for proper analysis rather than as an exercise in counting possibly self-interested or partially informed heads. In our view the Inquiry should not support any of the regulatory options it is putting forward in these questions unless it is sure that it has identified all their likely unintended and undesired consequences and rigorously analysed the costs and benefits of proposals. Counting heads does not do this. We note that some questions invite respondents to consider the potential *need* for further regulations rather than to consider the potential benefits *and* costs of suggested regulations.[3] Some other questions presume that government intervention is required and merely ask for opinions about the most appropriate form for it.[4] In short, we suggest that the questions have a heavy pro-regulatory bias.

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[3] See, for example, questions 22, 39 and 51-55.
[4] See, for example, questions 40-42, 44 and 45.