NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Commerce Commission's Draft Report on Mobile Termination Services

July 2009

1. Introduction

1.1 This submission on the Commerce Commission's 30 June 2009 Draft Report recommending the designation of mobile termination access services (incorporating mobile-to-mobile voice termination, fixed-to-mobile voice termination and short-message-service termination) 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 New Zealand interests.

2. Background

2.1 The Commission opened its formal investigations of the case for designating mobile termination in May 2004. In August 2005 the government asked it to reconsider its June 2005 designation recommendation. In April 2006 the Commission again recommended designation. In April 2007 the government rejected this recommendation and accepted deeds of agreement offered by Vodafone and Telecom. These deeds contained specified prices for mobile termination services through to March 2012. However, in May 2008 the Commission informed interested parties that it was considering another investigation into regulating mobile termination. It released an Issues Paper in August 2008 and announced the start of an investigation on 6 November 2008. Obviously acting under duress, Telecom and Vodafone offered new undertakings on 12 January 2009 and revised undertakings on 6 May 2009. 2degrees offered an undertaking on 12 January 2009 and Vodafone has made it clear that it felt obliged to offer 2degrees especially favourable terms in order to help it enter the market. On 30 June 2009 the Commission announced that it was recommending regulation of mobile termination and the rejection of these undertakings.

3. General comment

3.1 Telecom and Vodafone have been robust competitors in the mobile telecommunications market in New Zealand. The battle between them for market share has been intense and technology-driven. Competition is distorted by the Kiwi Share (now the Telecommunications Service Obligation). It is also limited by New Zealand's small market size. Having regard to these factors, the Business Roundtable has never been persuaded that the mobile telecommunications market is inefficient in an economic sense and that further regulation would improve it. Judging it or any market by the standards of a textbook model of perfect competition provides no useful guide for public policy.

3.2 We made our first submission on these issues in November 2004. We were concerned that the Commission's methodology was biased against irreversible investments in infrastructure and thereby likely to be detrimental to the longer-term interests of consumers. In particular, we submitted that the Commission needed to improve its methodology for dealing with the indirect costs of intrusive regulation, dynamic efficiency, and the burden of proof.

3.3 In response to the Commission's August 2008 Issues Paper inviting comments on whether it should revisit the issue, we submitted that it should not do so. We expressed continuing concerns about methodology, evidence, and the costs and uncertainty created by ongoing regulatory changes.

3.4 Government competition regulators have an incentive to justify their existence by forcing prices to consumers down and inducing entry. Any price in the economy can be forced down by regulation, but this is not generally in the interests of consumers (beyond the short term) or the economy. Moreover, the potential for conflict between these two goals is self-evident. One risk is that incumbents are forced to cross-subsidise new entrants in non-transparent ways. However, having committed itself to 'leveling the playing field' in order to facilitate entry, the regulator is no longer a neutral referee. It could find it difficult to stand by and watch the new entrant fail because the claim would always be that it had not done enough to level the playing field. It then risks finding itself trying to protect the viability of the new entrant by sheltering it from competition. Decisions become fundamentally arbitrary and discriminatory. The rule of law suffers.

3.5 These biases are subtle and difficult for a regulator to withstand. In section 5 we identify statements in the Draft Report that suggest that the Commission is heading down this path.

4. Rule of law

4.1 The rule of law requires that laws are known in advance (eg not applied with retrospective effect), are general in their application, and are applied fairly and consistently by an impartial judiciary, rather than arbitrarily or by decree. The presumption of innocence until proven guilty is also central to common law principles (see the Legislation Advisory Committee Guidelines on common law principles in general).

4.2 Businesses will not operate efficiently if they cannot know with any confidence in advance of major investment decisions (such as a decision to invest in 2G or 3G technologies) what pricing structures will be legal. By its actions since 2004 the Commission has created an environment in which incumbents can have no certainty about future pricing plans, even if they have reached firm deeds of agreement with the Crown. Businesses could be forgiven for thinking that the Crown is incapable of making credible (time consistent) commitments for those contemplating investments in communications infrastructure. The Commission's vacillations on national roaming and the government's planned interventions on broadband are adding to this uncertainty.

4.3 We view with particular concern the proposal in the Draft Report to change by regulation the mobile termination prices for 2011 and 2012 established in the 2007 deeds. We see a proposal to change established rules of the game in this way as comparable to the last government's retrospective intervention in the Overseas Investment Regulations which affected a transaction in Auckland International Airport Limited. A complaint about this intervention made by the

Business Roundtable to the Regulations Review Committee of parliament was substantially upheld. The intervention was viewed negatively by overseas investors in New Zealand and we have no doubt that action to alter deeds that were entered into in good faith would have similar repercussions.

4.4 Other features of the rule of law are that it should be non-discriminatory and impartial. With respect to the non-discriminatory aspect, the very nature of New Zealand's small size means that Commerce Act determinations will be likely to have highly specific effects. We also consider that the Commission is failing to eliminate bias against incumbents from its judgments. For example:

- paragraph xiv of the Draft Report suggests that lower termination rates might help 2degrees enter the market;
- paragraph xx suggests that lower rates could help Telecom compete with Vodafone; and
- paragraph xxi suggests that lower rates could help a fixed-line-only operator compete with Telecom and Vodafone; yet
- nowhere in the executive summary (at least) does the draft report acknowledge the balancing point that incumbents might not be earning *ex ante* supernormal profits on their jointly produced services.

4.5 We also note that a member of the Commission made a comment on a TVNZ *Sunday* programme on 12 July 2007 that appeared to favour 2degrees by apparently rejecting the commonplace commercial proposition – accepted earlier by firms such as Saturn and Bell South – that new entrants in business commonly expect to make losses until they have built up a satisfied clientele. In a rule of law context we are concerned that the comments of the member seemed to go as far as to prejudge the outcome of the inquiry. By contrast, on the same programme the minister for communications and information technology, Hon Steven Joyce, properly avoided any pre-judgment.

4.6 The lack of a right to appeal the merits of a Commerce Commission decision is also a concern in a rule of law context because it means that it can potentially act as judge and jury in its own interests. This limitation makes it harder to guard against bias.

5. Issues of information and analysis

5.1 Even in the absence of bias, arbitrary decision making by state regulators can be fundamentally unpredictable because of serious information problems. These problems can lead regulators who wish to reach a particular conclusion to make a multitude of questionable economic judgments that in total appear to justify that conclusion. Examples in the Draft Report include the judgments that:

- there is a separate wholesale market for mobile termination on each mobile network, when it is obvious that termination services can only be supplied jointly with other services (paragraph viii). As a Telecom submission in 2004 observed, when costs are jointly incurred their allocation amongst outputs is formally arbitrary;

- competition is limited – yet Vodafone reports that its annual customer turnover rate is 25 percent (paragraph ix);

- New Zealand's small population size might explain any finding of relatively few competing firms (paragraph x);

- prices higher than cost would represent a barrier to entry rather than an incentive to enter (paragraphs xiv, xiv and xix). It is as if the Commission thinks that a property right is a barrier to entry;

- the overall competitive effect can be assessed by looking at only one product in a joint product situation (paragraph xiv again);

- costs in fast moving high-technology industries are objective rather than subjective and the Commission is competent to make unqualified assertions about their levels (in paragraph xvii);

- the regulation mandating free local calling for fixed lines is disregarded in the analysis of mobile pricing in New Zealand, both absolutely and in relation to overseas comparisons;

- an ill-justified overseas benchmark is “sufficiently comparable" to New Zealand to establish a cost-based MTR (paragraph xxvi);

- regulating rates down to these hypothetical costs would be consistent with the Telecommunications Act's emphasis on recovering actual efficient *ex ante* costs in the New Zealand historical situation (paragraph xxvii);

- the assessed costs of 7.2 cpm for voice and 0.95 cpm for SMS are meaningful in a New Zealand context (paragraph xxviii);

- competition is enhanced rather than impaired by regulation to force prices down to a hypothetical cost (paragraph xxxiv);

- the extent of the waterbed effect in the case where the price of one of a number of joint products is being forced down by a regulator is likely to be as low as 0 - 50 percent (paragraph xxxvi);

- cost-based regulation will have substantial unquantified benefits but no substantial unquantified costs (paragraph xxxvii);

- a historically observed level of pass-through of 75 percent will rise to 100 percent when there is government control of mobile termination rates (paragraph 699). (This seems to confuse a historical correlation of endogenous variables with a causative relationship);

- “a demand elasticity of 0.60 was appropriate" for New Zealand, despite an enormous variation in estimated demand elasticities for other countries (paragraph 710). (However an appendix does present some sensitivity calculations);

- in the absence of any information about how the elasticity might change over time in this dynamic industry, the choice was arbitrarily restricted to two functional forms (paragraph 711);

- allocative efficiency would be achieved by setting prices equal to (perfectly observed) long-run marginal costs (paragraph 721). However, this rule assumes away the joint cost problem, would not allow common costs to be recovered and would not allow supernormal or subnormal profits to be achieved *ex post*;

- reliable estimates can be made of the long-run incremental cost of supplying retail fixed line-to-mobile calls (paragraphs 725-727). These "estimates" in Table 44 look more like guesstimates, particularly given the joint cost problem. Retail costs are assumed to be 18 percent of the retail price and common costs are assumed to be 10 percent of the "estimated" cost of the retail service. The resultant "estimate" for 2011 of 8.78 cents per minute is treated as definitive;

- allocative efficiency gains in the retail mobile services market can be estimated by assuming that a new entrant reduces the market price by 5 percent, increases the quantity of calls by 3 percent, and that the incremental cost of supplying retail mobile calls is known to be 15.8 cents per minute (paragraph xlvi and paragraph 792);

- all these assumptions can be combined to conclude that their effect in Table 5 is likely to "significantly understate" the overall net benefits from cost-based regulation of mobile termination (paragraph xxxviii); and

- there will only be gains in productive efficiency, innovation and efficient investment from regulating prices down to "estimated" costs (paragraphs xl and xlviii).

5.2 The highly contestable nature of some of these critical judgments is illustrated by the submissions summarised in the appendices to the Draft Report and other research. For example, empirical evidence suggests that waterbed effects have been significant with EU regulation – almost always a reduction in the MTR leads to an increase in fixed (access) or call charges, even when profits fall. To be fair, the Commission does use sensitivity analyses to some extent to test the sensitivity of its calculations to assumed values for fundamentally unknown parameters.

5.3 Naturally the problems of inadequate information apply to overseas regulators as well. In wrestling with these problems, the Commission uses problematic information and decisions by overseas regulators to guide and justify its own conclusions. Overseas regulators face similar information problems and are responding to similar incentives, so this procedure does not protect against bias. Moreover, such information is not necessarily comparable to New Zealand conditions and the Commission selectively departs from common overseas practice by rejecting transition periods for regulated price reductions and by benchmarking against modelled MTR costs and not against regulated prices. This is contrary to ACCC practice in Australia, for example.

6. Is this issue economically significant?

6.1 At first blush mobile termination charges are a non-issue from an end-user perspective since they transfer payments between suppliers but do not necessarily alter the quantum of industry-wide end-user payments. For example, bill-and-keep would eliminate termination charges but not alter the fact that end-users must continue to fund the costs of supplying existing network services if they are to be maintained.

6.2 The commercial reality is that a mobile network operator can only cover the very large joint, fixed and common costs of providing its network out of some combination of prices for origination, termination, access and value added services. The less the market, or a regulator, allows it to earn net revenue from another operator from termination fees, the more revenue it must get from other sources if it is to sustain its network.

6.3 The implicit proposition in the Draft Report is that incumbents can sustain a fall in revenue from end-users because they are currently earning larger profits than they need to make in order to maintain their networks and justify their earlier decisions to build and enhance them. However, the Draft Report makes absolutely no attempt to demonstrate that this assumption is valid. This is a fatal defect. It means that the Commission has no basis for asserting that the hoped-for allocative efficiency benefits exist.

6.4 If the Commission's recommended actions reduced profits by expropriating a portion of incumbents' sunk cost investments, the claimed gains in producer and consumer surplus from expanded demand at reduced end-user prices could actually be negative. The assertion that current prices are inefficiently high relative to costs (when costs include the need to obtain a normal return on sunk capital) depends critically on the assumption that overall profits contain an *ex ante* element of supernormal returns. (No matter how competitive the industry, firms can (and do) earn *ex post* supernormal or subnormal profits without giving rise to any monopoly concerns *per se*. Regulators who seek to transfer any *ex post*, apparently supernormal, returns that are not *ex ante* supernormal returns to other parties may actually create allocative inefficiencies.)

6.5 Moreover, while there may be in-principle benefits from regulation, does the magnitude of the expected benefits from regulating fixed-to-mobile termination justify politicising mobile telephony and entrenching lobbying, rent-seeking and property-right uncertainty for the foreseeable future? The Draft Report ignores these likely efficiency detriments and estimates only the overall allocative efficiency gains, ignoring the profitability question. It considers (paragraph xliv) that these might amount to around $50-$100 million in present value terms in the five years to 2015, depending on the assumed magnitude of the waterbed effect.

6.6 How significant are these numbers? Statistics New Zealand estimates that there are 1.6 million households in New Zealand so benefits of $50-$100 million in present value terms would represent a one-off gain of the order of $30-$60 per household – not enough to fill the petrol tank of the average car. But even this estimate may be misleadingly high. Conventionally, economists measure the efficiency gains from reducing monopoly profits as the deadweight loss triangle shown in Figure 19 on p 161 of the Draft Report. But this gain would only be of the order of 1/8th of the above $30-$60 gain per household in present value terms – on the basis of the higher figure, the equivalent of a bottle of inexpensive wine.

6.7 Moreover, to get to its $50-$100 million figure, the Commission has relied heavily on the additional assumption that retail fixed-to-mobile services would still be heavily over-charged relative to the incremental costs of supply if regulation stopped over-charging for termination. As explained in Figure 20 on p 163, if this situation exists the additional sales induced by forcing down the price for termination would add to the producer surplus. The assumed figure of 8.78 cpm for the incremental cost of supplying retail fixed line-to-mobile calls in 2011 is much lower than the assumed (factual) price of 21.73 cpm. It is the magnitude of the hypothetical gap and the associated *ex ante* profitability assumption that is critical to obtaining the $50-$100 million result.

6.8 An unidentified aspect of this assumed figure of 8.78 cpm is that it makes the regulation of mobile termination rates *per se* statistically insignificant from a household perspective. What is important for the $50-$100 million calculation is the hypothetical use of regulation to force down the price for retail fixed-to-mobile services to the 8.78 cpm level. Whether this is achieved directly or via forcing down mobile termination rates is a side issue.

7. Dynamic efficiency considerations

7.1 Economists have long recognised that the allocative efficiency gains from government regulation of private monopolies are likely to be small even if one ignores, as the Draft Report does, the dissipation of transfers of rents by the resources spent in lobbying regulators either to achieve the transfers or to oppose them. The above observations and calculations showing only small gains are therefore not surprising.

7.2 What is particularly disappointing about the Draft Report is that it seems oblivious to the consequences for dynamic efficiency of keeping the incumbents in a fast-changing industry uncertain about their legal property rights in 2G or 3G. The Draft Report does not acknowledge that uncertainty about property rights is generally considered to be bad for dynamic efficiency. Nor does it acknowledge the problems of bias and of assigning the burden of proof.

7.3 New Zealand-born US academic David Teece, a specialist in antitrust, has recently written a book on dynamic efficiency.[1] He argues that regulators should be reluctant to intervene when competing firms have highly skilled personnel who are capable of finding ways of undermining another firm's dominance – if a way can be found. Arguably New Zealand now has at least three mobile firms with that capacity and several more have commenced operations or are expected to do so before the end of 2009. (This suggests MTRs are not a barrier to entry as claimed.)

8. Other concerns

8.1 We regard the benchmarking aspects of the Draft Report as amateurish and naïve from a commercial perspective. No serious investor would invest in a New Zealand network on the basis of such assumptions about costs. It must be unnerving for investors to see assumed parameters that have a 'finger-out-the-window' feel to them

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[1] David J Teece (2009) *Dynamic Capabilities and Strategic Management: Organizing for Innovation and Growth*, Oxford University Press.

treated in the executive summary as if they provide a firm basis for policy recommendations.

8.2 Another disturbing aspect from a commercial perspective is the failure to investigate whether the assumed supernormal profits from monopoly actually exist, remembering that supernormal *ex post* profits (and losses) are also manifestations of competitive markets. Any signal that investors will be expected to bear *ex post* losses but not be permitted to retain *ex post* profits will be damaging for investment.

9. Conclusions

9.1 The government has signalled its concerns about poor regulation and is working to improve regulatory disciplines. The growth of poor quality regulation in recent years has been a major contributor, in our view, to the slump in productivity growth. New Zealand cannot go on adding to regulatory burdens while aspiring to raise productivity growth and living standards. Clear-cut benefits must be established to justify new regulations. If proposals to regulate mobile termination rates proceed they should be accompanied by a rigorous Regulatory Impact Statement.

9.2 We believe that much larger net benefits from regulation would need to be demonstrated for such proposals to pass an RIS test. It is hard to see a case that keeping a major industry in a state of uncertainty as to property rights for the best part of a decade for such meagre gains can be in the national interest, even if some confidence could be placed in them. We believe no confidence can be placed in the calculations of benefits in the Draft Report.

9.3 In our view, the Commission needs to address specifically the problem of whether its recommended actions would actually be an expropriation of sunk cost investments or a denial of *ex ante* supernormal profits. It also needs to acknowledge the economic costs to taxpayers of its own inquiries, the costs to private parties of participating in them (including the opportunity costs of the time of senior executives), and the costs of rent-seeking, lobbying, and associated property rights uncertainties. The fact that the present inquiry looks set to stretch to more than 18 months is itself a major concern.

9.4 The Commission's answer to concerns about parameter uncertainties should not be: 'Well, what numbers for crucial parameters should we be using'? The fact is that no one can be sure how the future will unfold, so opportunity costs are a matter of entrepreneurial judgment. While the Commission should try to make the best use of available information, it is critical that it interprets information in a manner that acknowledges the significance of the limited state of knowledge.

9.5 In our view the Commission should be much more forthright in acknowledging the serious information problems it faces in undertaking an inquiry such as the present one. The Draft Report's analysis of dynamic efficiency issues appears to be superficial, sweeping and biased. The Commission should be prepared to conclude, where appropriate, that it has no reliable basis for reaching a conclusion on even the sign of net benefits (positive or negative) from a proposed course of action. When such situations arise, we submit that the burden of proof should favour the preservation of the property rights of those who have already invested. This is consistent with both the rule of law and dynamic efficiency.

9.6 Our conclusions are therefore as follows:

- under no circumstances should the Commission recommend regulation of fixed-to-mobile voice termination because designation would overturn the provisions of the deeds for 2011 and 2012. This would be a flagrant breach of rule of law principles; and

- in the absence of (i) a much more rigorous analysis of the case for regulation and (ii) a demonstration that the magnitude of likely gains would be well in excess of those postulated in the

Draft Report, the Commission should abandon its proposals to regulate mobile termination services after 2012.

9.7 Finally, any public policy advice relating to fixed line-to-mobile issues needs to address the problems arising from the free calling distortion imposed by the Kiwi Share. If this is outside the Commission's jurisdiction it should at least note that other agencies should take it into account when assessing its recommendations.