NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Telecommunications Amendment Bill

August 2006

Executive Summary

- This submission on the Telecommunications Amendment Bill is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

- We submit that the measures in this Bill represent (i) a major taking of private property rights without an acceptable public-interest justification, (ii) a lack of due process, and (iii) a lack of consideration of the question of compensation. The minister of economic development, Hon Trevor Mallard, has stated that:

> We cannot expect private individuals – New Zealanders as well as foreigners – to commit long term to this country's prosperity if they are at risk of having their assets stranded or devalued by government intervention.

This statement is correct. We are at a loss to see how the government's action squares with it. This has implications for the security of investment and thereby the cost of capital right across the economy.

(i) Lack of a public-interest justification

- No acceptable public-interest justification for the measures has been provided. The regulatory impact and business compliance cost statement (RIS) in the Bill's explanatory note makes it clear that officials have not undertaken a quantitative cost-benefit analysis of the measures in the Bill. Such an analysis would focus on the impact of the proposed regulation on economic efficiency, represented by total (producer plus consumer) surplus, relative to the status quo.

- The estimates of consumer surplus benefits cited in the report are those of the Commerce Commission in 2003 and come to well under $100 million over a five-year period. By contrast, the losses in producer surplus, as represented in an approximate way by the fall in Telecom New Zealand's share price, are of the order of $3–4 billion. While the proposed measures are now more extensive than those considered by the Commission and it is claimed that consumer benefits have increased, it seems wildly implausible to postulate an increase in consumer surplus that would have to be more than 30 to 40-fold greater than

estimated by the Commission to exceed the fall in producer surplus and justify the proposed measures. At the very least, a new analysis should be required.

- The credibility of the RIS is further reduced by its one-sided, superficial and sometimes erroneous claims about economic benefits. We have not analysed it in detail because, as explained, we cannot see how plausible public benefits could conceivably exceed demonstrable public costs. However, we are aware of the submission being made by Bronwyn Howell of Victoria University. It contains a large number of criticisms of the analysis behind the Bill and concludes that a sound case for intervention has not been made out. We share in particular her concerns about the focus on platform-based competition (using incumbents' networks) rather than dynamic competition based on investment in new facilities, the factual errors and misrepresentations in the broadband debate, and the lack of evidence that unbundling and related measures have produced superior outcomes in other jurisdictions. We commend her submission to the committee's careful attention.

(ii) Lack of due process

- Due process requires that citizens not be punished except for a distinct breach of law established in an ordinary legal manner before a court or comparable body. Citizens must have the opportunity to hear and respond to the charges against them. Proper rules of evidence must apply and the judge must be impartial. Rights of appeal would apply. The Telecommunications Commissioner followed due process and recommended against the types of measures now in the Bill. It appears that the executive had prejudged the case and did not accept his conclusions. Subsequently, no such process has been followed, no distinct breach of law has been established, interested parties were not consulted and a draconian penalty has been imposed. This is an unacceptable way for any government to proceed.

(iii) Lack of consideration of compensation

- If a sound public-interest justification for the measures were established, we would be happy to support the Bill. However, in that event the issue of compensation would arise. A particular group (shareholders in Telecom) should

not have to bear the costs of the regulation in the interests of the wider public. Public Works Act principles should apply. The Cabinet Manual requires that compensation is considered where rights in private property are taken and if compensation is not to be paid, the legislation should make this clear. The minister of finance Michael Cullen emphasised the importance of the compensation principle in another context when he said:

> … no principled government could simply legislate to extinguish those [(customary) property rights] because that would be theft …
>
> Like any other property right, customary rights, where they are established, should not be taken without just compensation.

We have considered whether there might be grounds for denying compensation and doubt that they exist.[1] We submit that the issue of compensation needs to be addressed.

- We therefore recommend that the Bill be referred back to officials with an instruction to meet the Cabinet Manual requirements relating to cost-benefit analysis, due process and compensation and report further to the government.

- If the Bill proceeds, our submission recommends that a sunset clause be included in it; that the Telecommunications Service Obligation be abolished; and that ways should be found to restore the independence of Crown regulators from the executive.

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[1] We also note that a United Future MP (Gordon Copeland) currently has a member's bill before a select committee that would incorporate economic rights in the New Zealand Bill of Rights Act. If the bill does not apply to this situation, then what does it apply to?

Introduction

1.1 This submission on the Telecommunications Act Amendment Bill (Bill) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 Bills that take rights in private property need to have a sound public-interest justification, follow due process, and address the question of compensation. A failure to respect any of these principles is likely to have unintended and chilling effects on investment decisions. We fully endorse the statement by the minister of economic development, Hon Trevor Mallard, that:

> We cannot expect private individuals – New Zealanders as well as foreigners – to commit long term to this country's prosperity if they are at risk of having their assets stranded or devalued by government intervention.[2]

1.3 Section 2 of this submission examines the regulatory impact and business compliance cost statement (RIS) in the Bill's explanatory note to assess whether it establishes that the measures in the Bill are justified in the public interest. For reasons we explain we do not find it necessary for this purpose to investigate the robustness of the benefits claimed for these measures. However, we are aware of a detailed analysis by Bronwyn Howell of Victoria University that questions the validity of these claims. We commend her submission to the select committee. The key point about the RIS is that it admits that no cost benefit analysis of the proposed intervention has been undertaken.

1.4 Section 3 documents and interprets the large fall in Telecom New Zealand's share price in this cost benefit context. It compares the magnitude of this loss with what is known about the extent of consumer welfare benefits from the measures in the Bill.

1.5 Section 4 raises the issue of compensation for regulatory takings. It is informed by minister of finance Michael Cullen's statement, which we endorse, that:

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[2] Address to Hugo Group CEO Forum, 21 June 2006.

> ... no principled government could simply legislate to extinguish those [(customary) property rights] because that would be theft …
>
> Like any other property right, customary rights, where they are established, should not be taken without just compensation.[3]

1.6 Section 5 considers the question of due process. Section 6 presents our conclusions.

2.0 The lack of a public-interest justification for the Bill

2.1 The RIS is the main basis for assessing the case for a regulatory intervention. A commitment to quality regulation requires a sound RIS with a clear conclusion. The government is currently undertaking a review of regulations because of its concerns that some have had unintended consequences. This points to poor quality RISs in the past, as we have often observed in submissions on bills. The Ministry of Economic Development is the 'custodian' of the integrity of the RIS process, and is associated with the advice on this Bill. Because of its failure to produce a cost benefit analysis on an issue which is amenable to such analysis – as the inclusion of a cost benefit analysis in the Commerce Commission's report on unbundling demonstrates – MED has failed in its responsibilities. The RIS merely cites the 2003 estimates by the Commerce Commission of consumer welfare gains of the order of $30 million for full local loop unbundling and $75 million for unbundled bitstream access over a five-year period. While it considers that the relevance of these earlier conclusions is limited, it has nothing better to offer.

2.2 The RIS does not explain that the 2003 estimates are not a measure of the benefit to the community because they ignore the wealth citizens lose as investors. The Commission's estimates of the gain, net of this loss, were only $16 million and $26 million respectively. Such estimates are very small in the context of this industry, and little confidence can be placed in them anyway because of estimation errors. The Commission observed in the local loop unbundling case that "[s]mall changes in assumptions can have potentially

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[3] Hon Dr Michael Cullen, *A policy for the future*, Speech Notes, 11 February 2004, http://www.beehive.govt.nz/ViewDocument.aspx?DocumentID=18890. See also the speech itself at http://www.beehive.govt.nz/ViewDocument.aspx?DocumentID=18891 where the reference to confiscation as theft is repeated.

large effects on the results of the cost-benefit modelling".[4] The burden of proof should be on regulators and the government to establish that the benefits of an intervention exceed the costs by a reliable margin.

2.3 Having considered the issues extensively, the Commission gave cogent reasons for not recommending unbundling the local loop:

> The overall benefits from unbundling are not sufficiently persuasive to satisfy the Commission that a regulated solution is warranted. The experience of a range of other countries with regulated local loop unbundling does not lend weight to the case for New Zealand to follow suit. The levels of uptake of unbundled loops are small in relation to the number of available lines and the competition impacts difficult to discern.[5]

This finding by the Commission in itself discredits the assertion in the RIS that the measures in the Bill will align New Zealand regulation more closely with international best practice. In support of this conclusion, we note that a 2005 research paper by two American academics reported that no studies published in scholarly journals have quantified the effect of unbundled network element regulation on retail prices or consumer welfare. Furthermore, it reports that the US Federal Communications Commission is no longer trying to force incumbents to lease the unbundled network element platform.[6] How then can the RIS claim that such a measure is international best practice?

2.4 In the context of the point by the minister of economic development, Trevor Mallard, cited in section 1, it is noteworthy that the Commission recommended designating only a *limited* form of bitstream access in order to "as far as possible preserve Telecom's incentives to continue to invest in that network and any future networks".[7]

2.5 We conclude that it is merely a statement of fact to say that the RIS has not demonstrated that the proposed measures are clearly in the public interest, even if its claims about benefits were accepted.

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4 Commerce Commission, *Telecommunications Act 2001, Section 64 Review and Schedule 3 Investigation into Unbundling the Local Loop Network and the Fixed Public Data Network*, Final Report, Public Version, December 2003, para 795.

5 Commerce Commission, *op cit*, para (v). See also para 792 for a fuller statement of the disappointing gains from a significant number of countries.

6 Jerry Ellig and Nicholas Taylor, 'What did the unbundled network element platform cost?', *Journal of Communications Law and Policy*, Fall, 2005, http://commlaw.cua.edu/articles/v14/Ellig_Taylor.pdf.

7 Commerce Commission, *op cit*, p 811.

3.0 Telecom's share price fall in a cost-benefit context

3.1 The reduction in a company's share price in response to an announcement can be interpreted as the market's assessment of how much some new information has reduced the present value of the firm's profits or producer surpluses. This is because share prices reflect shareholders' assessment of the value today of the current and future benefits they expect to derive from their share of current and future company earnings. Producer surplus measures the difference between a firm's revenue and its operating costs. A change in the share price that is not associated with changes in non-operating costs (such as interest payments) is a measure of the change in producer surplus. We made these points at length when we appeared before the Telecommunications Commissioner at the time of his inquiry but he seemed unable to grasp them. He apparently believed share prices were unrelated to the producer surplus estimates he was required to make.

3.2 The announcement of the government's proposals caused a major reduction in Telecom's share price, both on impact and in subsequent weeks. However, there would also have been a pre-announcement effect as the possibility of more extensive regulation was well recognised in the market. Capital Economics Limited recently suggested that the overall costs to shareholders of the measures in the Bill might be of the order of $4 billion:

> According to the *Dominion Post*, 22 June 2006, Telecom's share price "has been in free fall since the Government said on May 3 that it would force open Telecom's network to broadband rivals. About $3 billion has been wiped off Telecom's value in six weeks." The same article reports that the share price close of $4.06 on 21 June was a 13-year low and represented a fall of more than 25 percent since early May. What these statistics establish is that the Bill's measures were more draconian than investors had been expecting. As such they do not measure the full value of the taking. The share price prior to May 3 would already have been lower by the market's expectation of the government's likely actions. The extent of this effect is probably impossible to determine with any precision. A survey of the Telecom analysts in the market might provide a subjective ball-park estimate. I would not be surprised if it added another $1 billion to the likely scale of the taking. An uncompensated taking of the order of $4 billion or even $3 billion is a major tax in a New Zealand context.[8]

Since that letter was written, Telecom's share price has fallen further.

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[8] Letter to the Legislation Advisory Committee, 17 July 2006.

3.3 Such estimates of the loss in producer surplus for Telecom dwarf the Commission's estimates of benefits to consumers. They also make a nonsense of the bald assertion in the RIS that the "increase in consumer welfare is expected to outweigh any decrease in welfare for other segments of society". We acknowledge that the loss for shareholders in Telecom might be offset to some extent by gains for shareholders in some other telecommunications companies. However, by the same token, there could also be losses in producer surplus for companies that were planning to compete with Telecom's platform. What is clear is that the only benefit figures available to officials were miniscule compared with the cost to Telecom's shareholders.

4.0 Failure to address the question of compensation

4.1 When private property rights are taken for the public's benefit, compensation should be paid. The Legislation Advisory Committee's Guidelines (LAC Guidelines) state that this is a fundamental common law principle. Parliament should only put it aside for good reason. Moreover, where it does this, it should do so explicitly. The Bill fails on all three counts. It fails to provide a good reason for taking so much wealth from Telecom shareholders (see section 3 above), to consider compensation, and to use explicit language to make it clear that no compensation is to be paid.

4.2 One possible defence of the absence of compensation provisions in the Bill might be that the measures only take current or future monopoly rents away from Telecom shareholders, which they were not legally entitled to enjoy in the first place. Further, under this defence, future regulators will set access prices for competitors that are high enough to allow Telecom shareholders a normal return on sums invested. We believe any such arguments would be spurious:

- the rights of investors in Telecom were legitimately acquired. Prior to privatisation the telecommunications market was fully deregulated. Options like structural separation were considered at that time and rejected as having no strong justification. Now investors who have committed no wrongdoing are faced with a proposed change in the rules of the game;

- the Telecommunications Commissioner considered the monopoly argument for unbundling extensively, and rejected it. The goal of removing monopoly rents was not one of the stated policy objectives in the RIS, nor was it used as a reason for choosing the measures in the Bill. These are directed at forcing access to Telecom's network (implicitly on terms other than commercial terms) which would diminish the value of the company and reduce its share price, irrespective of the existence of any monopoly rents; and

- the market is indicating that it has no confidence that value will be restored by fair access price decisions by the regulator. Given the artificial WACC-based nature of the Commerce Commission's determinations, this is a logical reaction.[9] Academics at Victoria University have criticised the downward bias in the Commission's methodology.[10]

4.3 The argument ignores other more plausible explanations for the fall in Telecom's share price. These include (i) expropriation of a portion of the normal returns on past sunk investments; (ii) the expropriation of *ex post* above-average returns from Telecom's copper wires as a result of the discovery of ADSL (which should not be expropriated because of the need to preserve the incentive to find and exploit such innovations in the future), (iii) reductions in the perceived value of future investment opportunities for Telecom due to the increased transaction costs (such as increased industry consultation and litigation) associated with more heavy-handed regulation and (iv) an increased cost of capital for Telecom as a result of perceptions of increased risk of uncompensated regulatory takings.

4.4 One of the principles in the LAC Guidelines is in favour of the liberty of the subject. This puts a burden of proof on those who would take the subject's property rights without good reason and due process.

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[9] WACC is the weighted average cost of capital.

[10] See Glen Boyle, Lewis Evans and Graeme Guthrie*, Estimating the WACC in a Regulatory Selling*, mimeo, March 2006.

5.0 Lack of due process

5.1 According to Rt Hon Sir Geoffrey Palmer, chairman of the Legislation Advisory Committee, Dicey's first conception of the rule of law was that:

> … no one may be punished or made to suffer in body or goods except for a distinct breach of law established in the ordinary legal manner before the courts.[11]

It is implausible that Telecom would knowingly violate the law. Its obligation is to maximise shareholder value subject to complying with the law. Indeed, the Bill makes no case that Telecom was violating any law. The representatives of its shareholders were not accused of distinct breaches of the law nor given the opportunity to answer any accusations in the ordinary manner before the courts.

5.2 Far from arising as a result of due legal process, the measures in the Bill appear to be motivated by politics and a misguided conception of competition rather than good public policy analysis, with the losses being concentrated on the small proportion of the population that holds Telecom's shares. The situation as regards due process was made worse by the prime minister's reported comments to the effect that the executive had prejudged the Telecommunications Commissioner's decision in 2003, and did not accept it.[12] We submit that criticism of an independent regulatory body would only be justified if it failed to gather and weigh all permissible evidence impartially and competently in accordance with existing law. Such comments by the executive must seriously damage investor confidence that a government regulator will operate in an independent, arm's-length way.

6.0 Conclusions

6.1 The measures in the Bill have not been demonstrated to be in the public interest and they fail to meet Cabinet Manual requirements. We submit that the Bill should be referred back to officials and the Legislation Advisory Committee. Officials should be required to undertake a thorough, impartial cost-benefit

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[11] See Rt Hon Sir Geoffrey Palmer, 'The New Zealand Constitution and the Power of Courts', *Transitional Law & Contemporary Problems*, Vol 15, No 2, Spring 2006.

[12] *Sunday Star-Times*, 'PM's bad-news call for telecoms commissioner: Helen Clark says the government's man did not deliver on unbundling', May 14, 2006.

analysis of the measures in the Bill and the Legislation Advisory Committee should advise the government on what steps are needed for the Bill to comply with the Committee's guidelines, in particular those relating to due process and compensation.

6.2 Should the Bill proceed, we recommend that:

(i) it be amended to include a sunset clause that terminates all provisions after 5 years, the Commerce Commission's preferred time horizon for analysing monopoly issues. At that point the case for any extension should be explicitly addressed;

(ii) officials review the Telecommunications Service Obligation (Kiwi Share) with a view to terminating it, given the problems it is causing for competition in this sector, including the disincentive to broadband uptake (because dial-up modem access is free); and

(iii) the committee consider how the executive might assure the investment community that its regulatory agencies are independent and that it will not prejudge or overrule their decisions without good reason and due process.