

# **Local Loop Unbundling: Some Economic Issues**

Presentation to Commerce  
Commission

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- My name is Geoff Bertram. I am Senior Lecturer in Economics at Victoria University of Wellington, and a partner in Simon Terry Associates
- TelstraClear has asked me to comment on some economic issues raised by Telecom and their consultants Charles River Associates (Asia Pacific).

# “Real competition” versus “pseudo competition”

- Telecom has argued that: “Competition requires real competitors. Firms which rely on a regulated share of the assets of their competitors are not true competitors.” (Telecom submission paragraph 5.)
- If this were to be accepted, it would follow that “promotion of competition” would become synonymous with “promotion of facilities-based competition”.
- The Telecommunications Act 2001 would then be interpreted as having had the purpose of promoting the construction of duplicate bypass network facilities, even where they are redundant and economically wasteful. I do not believe that that was Parliament’s intent.

# “Tension between regulation and competition”

- Telecom has asked the Commission to “bear in mind” some alleged “tension between the goal (promoting competition) and the method (regulation)”
- Telecom’s quotations are all out of context
  - Stigler’s concern is with regulatory capture
  - Kahn speaks of regulation and competition as “competitive rather than complementary” only in the context of anti-competitive regulation
  - Breyer did not reject the principle that facilities sharing could be pro-competitive

# **Economic theory does not establish any necessary conflict**

- Regulation is unnecessary where workable competitive prevails
- When market failure occurs, regulatory intervention is appropriate, provided only that it is cost-effective
- The issue is to achieve a “proper mix” (Kahn)

# CRA on productive efficiency

- CRA argue unbundling will have a negative impact on productive efficiency.
- CRA claims that Telecom is already at the limit of feasible productive efficiency
- CRA effectively claim this was achieved within 2 years of privatisation in 1990
- This is argued on the basis that various commercial disciplines are confronted by Telecom's management

# Comments on CRA's productive efficiency claims

- I do not agree with CRA's argument that privatisation in 1990 must in some way have shifted Telecom to the productive efficiency frontier within two years.
- CRA provides no empirical evidence to support there claims
- Nor does CRA offer evidence that Telecom has solved the principal-agent problem
- Given the extent to which Telecom retained and defended a monopoly position for several years after privatisation, I would expect it to have faced weaker disciplines than other private commercial firms in fully competitive markets.

# Redistribution of Surplus as a Welfare Benefit

- Both CRA and Telecom appeal to a supposed “conventional approach” to the treatment of transfers in a cost benefit analysis.
- CRA, in its paragraph 80, for example, argues that “the conventional approach ... is to focus on net efficiency gains accruing to society as a whole rather than the consumer surplus. The rationale behind this is that over the long term end-users benefit from any increase in economic efficiency regardless of to whom the gains initially accrue...”

# CRA substantially misrepresents the issue

- CRA claims that no distinction can be drawn between the interests of end-users and society as a whole
- This is not a conventionally-accepted position
- Nor is it likely that the interests of end-users and those of society converge in the long run in such a way as to leave end-users indifferent about monopoly rent transfers

# **Cost benefit analysis must identify the target group whose net benefit is to be calculated**

- If the analysis is conducted from the standpoint of society as a whole, then some rule of thumb must be used to weigh up the gains and losses of the various individuals or groups of which the society is made up (the issue of distribution).
- If the analysis is conducted from the standpoint of end-users as a group, then the costs and benefits to be considered will be those which are of clear relevance to end-users, as distinct from society as a whole

# CRA advances an extremist Chicago position

- CRA tries to conflate consumer-focused analysis into social analysis, by alleging that in the long run the interests of consumers cannot be separated from those of society as a whole.
- This argument is immediately recognisable as the “total surplus standard” of Bork, Posner and the Chicago School
- This position has failed to gain acceptance in the courts of any major jurisdiction to date, and has not been explicitly written into the competition legislation of any country known to me.

# The *Superior Propane* decision

- The Canadian Federal Court of Appeal in *Superior Propane* rejected the Bork/Posner position  
*Canada (Commissioner of Competition) v. Superior Propane*, 2003 FCA 53.
- The Canadian Competition Act requires the Competition Commission and Tribunal to take specific account of the identities of the various parties to any transfer, and to weight them according to some clear and explicit set of criteria.
- The *Superior Propane* precedent, combined with the 2001 amendment of New Zealand's Commerce Act to include explicit reference to the interests of consumers in the long title of the Act, refute CRA's suggestion that there exists some clearcut "conventional" warrant for rejecting OXERA's measurement methodology.

# The Commission's approach to Wealth Transfers

- OXERA's cost-benefit analysis assumes end-users are the group whose interests are to be advanced by the Commission.
- Therefore all costs and benefits were evaluated from the end-user standpoint. This is an entirely conventional cost benefit approach, provided that it can be established that end-users are the appropriate target group whose welfare is to be advanced.
- This is the proper way to interpret "end-user" in section 18 of the Telecommunication Act 2001.

# s.18 does not involve a “public-benefit test”

- Certain sections of the Commerce Act direct the Commission to evaluate “benefit to the public” rather than benefit to consumers. The main examples are s.61(6) (authorisation of restrictive trade practices) and s.67(3)(b) (authorisation of mergers or acquisitions).
- In those cases the Commission undertakes a “public benefit test”, in the design of which it is necessary to adopt some rule of thumb in relation to the distribution effects of wealth transfers.
- LLU does not fall under the public benefit test guidelines. The analysis involves not a public benefit test but an end-user-focused test, comparable to the consumer-welfare test required by s.52 of the Commerce Act

# Long-run versus short-run

- Telecom seems to confuse the long run with a time period far in the future (e.g. paragraph 117(a)). This is incorrect if the term “long run” is interpreted to accord with normal usage in economic theory.
- Insofar as unbundling results in an immediate and sustainable transfer of wealth from Telecom to end-users, this is a long term benefit
- In a discounted-present-value analysis, such immediate transfers carry greater weight than benefits far in the future, especially when those future benefits are uncertain and speculative.

# Microeconomic theory

- Professor Quigley has sought to rebut the DSF arguments by addressing four main issues:
  - *whether Telecom's vertical integration may have an efficiency justification;*
  - *whether Telecom's vertical integration is a barrier to efficient entry by TelstraClear;*
  - *whether there are tradeoffs among allocative, productive and dynamic efficiency which the Commission ought to consider;*
  - *whether the literature in microeconomics supports the approach taken by DSF.*
- The first three of these must be resolved on the facts. I shall focus here on relevant economic theory

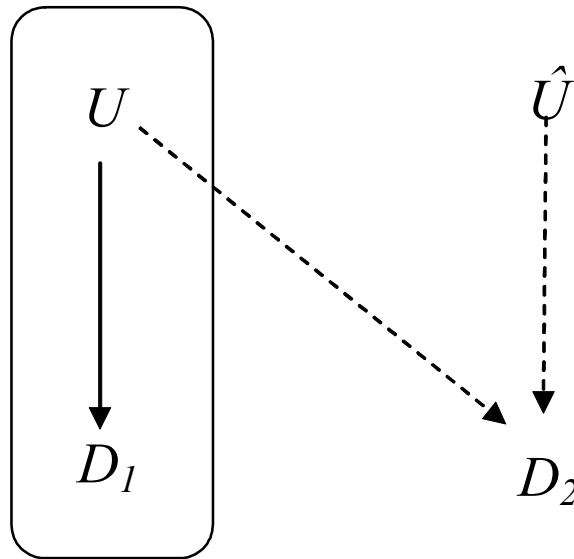
# The issue is vertical foreclosure as a means of raising rivals' costs

- Unbundling is an effective means to eliminate vertical foreclosure of its competitors by Telecom.
- The relevant economic theory is therefore that which addresses the issues of vertical foreclosure and “raising rivals’ costs”.
- In my opinion Professor Quigley’s review paper fails to illuminate that debate.

# **“A firm may only take its monopoly profit once”**

- This proposition used to appear regularly in the economics literature, as the conclusion from a comparative-static analysis resting upon very restrictive assumptions about the conditions under which vertical integration is hypothesised to occur.
- This is ironic, given the emphasis which Telecom and CRA have placed upon the importance of dynamic analysis.
- The result does not hold in a world of strategic behaviour.

# The Rey-Tirole (2003) model of vertical foreclosure



Total cost of bypass is  $C_{\hat{U}}$

Player  $D_2$  incurs lowest possible cost of its upstream input

$$C_2^{Input} = \min(p_U, C_{\hat{U}})$$

End-users pay demand-determined price  $P = P(q_1 + q_2)$  for market quantity  $Q = (q_1 + q_2)$

# Will technical progress be faster with or without unbundling?

- The Commission should ask itself whether the sort of dynamic gains for consumers described by Professor Hausman in his submission must necessarily be supplied by the incumbent, or whether innovations of this sort might more rapidly and effectively be brought to the market by new entrants using unbundled local loop facilities.
- I find nothing in Professor Hausman's paper to demonstrate that new entrants are less effective innovators with respect to new broadband products than the incumbent.
- The competitive market process is the ultimate source of dynamism.
- Sheltering vertically-integrated incumbents from competition. is more likely to retard the pace of technical progress.