



# **Economic Critique of the OXERA Unbundling Cost Benefit Analysis**

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# Introduction

**CRA report dated 29 October 2003 provides an economic critique of OXERA's CBA**

**Wide range of issues raised but many of the points have been covered by Professor Hausman today**

**This presentation is limited to considering the implications of unbundling for productive efficiency**

# Productive Efficiency Implications of Unbundling

## *Introduction*

### **OXERA assumes that unbundling would place extra productive efficiency pressure on Telecom**

- Claim unbundling assists entry, increases competition and thus increases the pressure on Telecom to improve productive efficiency

### **The results obtained by OXERA are likely to be highly sensitive to variations in this parameter**

- Network Strategies notes that a reduction in OXERA's productive efficiency parameter of 3 percent to 2 percent entirely eliminates the claimed benefits of full unbundling

# Productive Efficiency Implications of Unbundling

## *Introduction*

**In our view, unbundling will reduce the pressure on Telecom to improve productive efficiency by comparison with the counterfactual**

**In this presentation we:**

- Explain why productive efficiency will be reduced
- Consider the likely impact of unbundling on the productive efficiency of Telecom

# Productive Efficiency Implications of Unbundling

## *Introduction*

**It is true that increased competitive pressure on a firm can result in productive efficiency gains**

**But:**

**Unbundling is regulation not liberalisation of Telecom's network**

**The extent to which unbundling will generate sustainable competitive pressure is unclear**

# Productive Efficiency Implications of Unbundling

## *Reduction in pressure #1*

### **Efficiency gains are normally the basis for commercial advantage**

- With unbundling firms are forced to share the benefits of efficiency gains with their competitors

### **The benefits of the option that unbundling provides to entrants is magnified by efficiency gains**

- Entrants benefit from those investments that create productive efficiency gains but do not have to share the costs of investments that do not succeed in increasing productive efficiency

# Productive Efficiency Implications of Unbundling

## *Reduction in pressure #2*

**Unbundling of network elements inevitably leads to entrants attempting to persuade the regulator to require the incumbent to configure its network to benefit the entrant(s)**

- Both the process and the compromise network configuration that results will reduce productive efficiency

**Unbundling reduces the incentives to invest in new technologies that will bypass Telecom's network**

- Leasing unbundled elements at cost is invariably cheaper than bearing the risk of sunk investment

# Productive Efficiency Implications of Unbundling

## *Reduction in pressure #3*

### **The implications of this analysis are that**

- The incentive to make those efficiency gains is lower
- The further into the network that unbundling is mandated, the greater the reductions in productive efficiency are likely to be

**If unbundling generates sustainable competition then there may be some productivity benefits to offset against these costs**

- But, where is the evidence that unbundling does increase productivity?

# Productive Efficiency Implications of Unbundling

## *Reduction in pressure #4*

**The US has had unbundling for 7 years**

**So far as we are aware there is no credible study showing that unbundling has increased the productivity of US wireline telephony or of the RBOCs**

**Our understanding is that the FCC publishes the relevant data**

**If there is any empirical evidence to demonstrate the proposition that unbundling promotes efficiency, OXERA had every opportunity to collect it and put it in their report – but they provide absolutely none.**

# Productive Efficiency Implications of Unbundling

## *Impact of Unbundling on the Efficiency of Telecom*

**OXERA claims to rely on Dabler et al (2001) and Martin and Parker (1997) for its assessment of changes in efficiency that will result from unbundling**

**These studies analyse the impacts of privatisation and liberalisation on productive efficiency – they do not analyse the impact of regulation**

**These studies are therefore not relevant for the consideration of unbundling**

**Even if relevant, they do not support the use of 3 percent; in fact, the Dabler study finds that the rate of TFP growth has often declined post-liberalisation**

# Productive Efficiency Implications of Unbundling

## *Impact of Unbundling on the Efficiency of Telecom*

**Telecom is a wholly privately-owned firm - provides Telecom with strong incentives to maximise profits. has:**

- Efficiency-based cost reductions = key part of maximising profits.

**Telecom avoids the productive efficiency losses associated with the confused objective functions and governance structures of wholly or partly state-owned firms such as Telstra**

**Since privatisation in 1990, Telecom has:**

- Faced an increasing degree of competition in various markets, eg, long distance, CBD voice and data access, mobile
- A history of large and expert shareholders (Bell Atlantic (later Verizon) and Ameritech at privatisation)

# Productive Efficiency Implications of Unbundling

## *Impact of Unbundling on the Efficiency of Telecom*

**The claim that Telecom is inefficient, and has not had incentives to seek out cost reductions in the past, is inconsistent with the evidence on Telecom's management and strategy.**

**Staff remuneration features incentive contracts designed to reward increases in productive efficiency (eg, the EVA Incentive Scheme)**

**Telecom outsources the provision of much investment to providers operating in a competitive market (eg, IT to EDS; wireline network development to Alcatel, cellular maintenance to Lucent and Ericsson)**

# Productive Efficiency Implications of Unbundling

## *Impact of Unbundling on the Efficiency of Telecom*

**We note that in three of OXERA's four models, Telecom has a very high ranking (1<sup>st</sup>, 3<sup>rd</sup> and 5<sup>th</sup> out of 53 firms)**

**OXERA's fourth model ranks Telecom as being 30<sup>th</sup>, but as IBM points out, the methodology is flawed**

**Thus Telecom is, on most measures, at least as efficient as the RBOC's in the US (despite 7 years of unbundling)**

**Accordingly, OXERA's own study is consistent with the theoretical prediction that Telecom is already a relatively efficient firm**

# Productive Efficiency Implications of Unbundling

## *Conclusion*

**Rather than incorporating a positive productive efficiency adjustment into the factual, OXERA should have noted that:**

- Unbundling will reduce the incentives for Telecom and its competitors to make the investments that will increase productive efficiency; and
- There is no evidence that unbundling – either by promoting competition or by other means – has increased productive efficiency in those countries where it has been in place for a substantial period