



SUPPLEMENTARY SUBMISSION ON LEGAL ISSUES

12 NOVEMBER 2003

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Introduction

1. This supplementary submission is in response to the TelstraClear submission dated 29 October 2003 and the recent decision in *Brambles New Zealand Limited v Commerce Commission* (High Court, Auckland, CIV 2115-03, 24 October 2003, O'Regan J and Kerrin M Vautier CMG) ("*Plastic Crates*").
2. It addresses the following issues:
 - A. NATURE OF THE DECISION REQUIRED BY SECTION 64
 - B. MARKET DEFINITION: SUBMISSIONS ON *PLASTIC CRATES*
 - C. JURISDICTION TO REQUIRE A REFERENCE UNBUNDLING OFFER AND APPOINT AN INDEPENDENT REFEREE

A. NATURE OF THE DECISION REQUIRED BY SECTION 64

Introduction

3. This section addresses TelstraClear's 29 October 2003 submission in relation to the nature of the decision required under section 64. TelstraClear argues that:
 - the Commission's Draft Report places undue influence on a quantitative CBA performed by a third party, instead the Commission should simply make its own informed decision (paras 3.1, 3.8-3.10, and 3.15);
 - the Commission need not find a direct causal link between unbundling and the promotion of competition, instead it should ask whether the "competitive environment" would be improved by unbundling.
4. In summary, Telecom submits that:
 - (a) It is not only appropriate for the Commission to conduct a quantitative CBA, it is required to do so by law;
 - (b) The burden of proof for establishing the desirability of unbundling should rest on its proponents and a high standard of proof (at any rate, no less than the civil standard) should be required; and
 - (c) When the Australian authorities referred to by TelstraClear are looked at in context, the concepts of causation and *actual* effects on competition are in fact all relevant in Australia as well as New Zealand.
5. These points are expanded on below.

Use of a quantitative CBA

6. In *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429 at 447 Richardson J commented that:

...there is in my view a responsibility on a regulatory body to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits.
7. This passage has since been cited with approval in a number of cases including *Ravensdown Corporation Ltd v Commerce Commission* (High Court, Wellington, AP 168/96, 9 December 1996, Panckhurst J and Professor Lattimore) and *Rugby Union Players' Association Inc v Commerce Commission* (No 2) [1997] 3 NZLR 301.
8. In a paper titled *The Evaluation of Public Benefit and Detriment under the Commerce Act 1986* (Commerce Commission Occasional Paper No 7, February 1998) then Commerce Commission Chief Economist Dr Michael Pickford noted the Courts' approval of quantification and said:

The Commission believes that it is under an obligation to use quantification to the extent that it is feasible, albeit making allowance for the uncertainties inherent in any such exercise.
9. This is standard Commission practice.
10. With respect to TelstraClear's submissions on the use of CBAs internationally:

(a) Australia

Telecom agrees that quantitative CBAs are less a part of the regulatory landscape than in New Zealand. However, this may be changing (see *Application by Virgin Blue for Declaration of Airside Services at Sydney Airport* currently before the National Competition Council). Perhaps harmonisation will assist the development of this approach in Australia.

(b) United Kingdom

With respect to the position in the United Kingdom, TelstraClear states that (para 3.10):

Although Oftel performed a cost benefit analysis as part of its decision to regulate local loop unbundling in the UK, this was primarily used to determine which type of regulation was appropriate. The cost benefit analysis performed by Oftel was only part of its entire decision making process...

This statement misrepresents the process followed by Oftel. In a document entitled *Access to bandwidth: Proposals for action* (July 1999), Oftel proposed five possible regulatory options to improve access to bandwidth in the United Kingdom. Following feedback from industry participants, Oftel reached the view stated in *Access to bandwidth: Delivering Competition for the Information Age* (November 1999), based on a qualitative analysis, that unbundling was the best option. Having qualitatively determined the best option, Oftel then undertook a quantitative cost-benefit analysis of this option to determine whether it should go ahead (Oftel, *Delivering Competition*, November 1999, paras 2.27-2.29).

Oftel has consistently relied on CBAs in making other regulatory decisions - for example, *Review of the Charge Control on Calls to Mobiles*, 26 September 2001 (Chapter 8), *Final Direction relating to a dispute between Energis plc and BT over BT's rearrangement charges*, 30 January 2003 (Annex), *Consultation on access codes for directory enquiry services*, November 2000 (Annex C), *Freephone Numbering*, December 1999 (Chapter 3).

Adoption by the Commission

11. Telecom submits that - if rigorously conducted - a CBA should perform an important role in the Commission's decision-making. Indeed the Commission is under "an obligation to use quantification to the extent that it is feasible".
12. The Commission has attempted to discharge this responsibility by engaging an outside consultant, OXERA. In relation to the OXERA report, Telecom repeats its submission (para 154, 29 October 2003) that:
 - (a) the OXERA CBA is not an appropriate framework or of a standard suitable for being used to justify a recommendation in favour of unbundling;
 - (b) using the OXERA framework, but correcting errors produces a negative "net benefit";
 - (c) looking at OXERA's predicted benefits on face value, but in the context of telecommunications revenue generally and the potential dynamic efficiency costs, shows that the case in favour of unbundling is unconvincing at best; and

- (d) the Commission has been let down by consultants whose model did not address the task set for the Commission under section 64 or the Schedule 3 investigation. The OXERA report is demonstrably an unsound basis from which New Zealand's telecommunications industry investment decisions and service definitions could be based.

13. In other words, although the OXERA CBA could be used to say that the case in favour of unbundling has not been made out, it raises so many data, methodological and conceptual issues that it lacks the robustness which would be required for the work to be adopted by the Commission in recommending unbundling. Furthermore, given all the criticisms which have been raised in relation to the OXERA CBA, to rely on it would contravene the administrative law concept of "probative evidence", and to rely on it without expressing confidence in its robustness could be seen as an unlawful delegation of decision-making authority.

Burden and standard of proof

14. Telecom refers the Commission to paragraphs 70 to 73 of its 29 October 2003 submission where it is submitted that:

- (a) the burden of proof should rest on the proponents of unbundling;
 (b) a high standard of proof should be required; and
 (c) a high hurdle rate should be set.

15. The Commission's decision under section 64 requires it be satisfied that the case for unbundling is made out to **at least** the civil standard of proof which applies in relation to clearance and authorisation applications under the Commerce Act (*Foodstuffs (Wellington) Co-operative Society Ltd v Commerce Commission* (1992) 4 TCLR 713 at 721 HC). In the *Foodstuffs* case, Greig J, delivering the judgment of the Court, described the standard to be met in order for a clearance application to be granted:

the commission has to be brought to the point where it is satisfied, that it is more probable than not, that as a result of the acquisition a person would not be or be likely to be in a dominant position or have that position strengthened, noting that these phrases are conditional or doubly conditional because it is "would be likely" and not just "likely". If it is not carried to that point then it will not be satisfied and will be in the position set out in s 66(3)(b).

16. Given the role of the Commission's recommendation in the Minister's decision-making process, it is appropriate to have regard to the Ministry of Commerce's Recommended Guidelines for Preparing Regulatory Impact Statements which states (emphasis added):

19. Government interventions should be based on **clear evidence that a problem exists and that government action is justified.**

(A Guide to Preparing Regulatory Impact Statements, 16 March 1999).

17. In other words, in order for the Commission to make a recommendation in favour of unbundling, there must be (at least) clear evidence which satisfies the Commission, on (at least) the balance of probabilities that:

- (a) there will be a competition problem in 5-10 years time;
 (b) unbundling will promote competition to solve this problem; and
 (c) unbundling will produce a net benefit taking into account the full range of costs and benefits.

The meaning of "to promote competition"

18. TelstraClear's submission on this point is that (paras 3.4-3.6):
- The "promoting competition" standard does not require that the Commission find a direct causal link between unbundling and an increase in broadband penetration nor to quantify that link. The "promoting competition" standard requires only that the Commission satisfy itself that designating unbundling will create the conditions or environment for improving competition.
19. TelstraClear draws the following three key conclusions from the relevant Australian authorities: (para 3.19)
- (a) Competition is promoted where there is an improvement in "the opportunities and environment for competition".
 - (b) Whether the opportunities and environment for competition would be improved requires a comparison between the anticipated future opportunities and environment for competition *with* the proposed regulatory intervention and... *without* the proposed regulatory intervention. The current position provides an indication of the future competitive state without intervention, against which to compare the anticipated future competitive state without intervention.
 - (c) It is not necessary for the decision making tribunal to be satisfied that some actual increase in competition will follow, or is more likely than not to follow, or will occur within a particular period of time.
20. Telecom submits that the comparison between the Australian decisions in relation to the promotion of competition and the meaning of section 18 of the Telecommunications Act is misleading.
21. This is because:
- (a) The New Zealand framework combines issues of causation, dynamic efficiency and the costs and benefits of regulation into a single requirement that intervention "promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand".
 - (b) In contrast the relevant Australian legislation requires the relevant decision makers to look at the promotion of competition separately from the issue of overall welfare.¹ In the Australian context, it is within the "public interest" limb

¹ The *Sydney International Airport* [2000] ACompT 1 (1 March 2000) and National Competition Council, *The National Access Regime: Guide to Part IIIA of the Trade Practices Act 1974* (December 2002) consider Part IIIA of the Trade Practices Act. The *Duke Eastern Gas Pipeline Pty Ltd* [2001] ACompT 2 (4 May 2001) and *Moomba to Sydney Pipeline System: Revocation Applications under the National Gas Code* (National Competition Council, November 2002) Applications consider the National Gas Code.

The relevant provisions are:
Part IIIA Trade Practices Act 1974, s 44G

Limits on the Council recommending declaration of a service

- (1) The Council cannot recommend declaration of a service that is the subject of an access undertaking in operation under section 44ZZA.
- (2) The Council cannot recommend that a service be declared unless it is satisfied of all of the following matters:
 - (a) that access (or increased access) to the service would promote competition in at least one market (whether or not in Australia), other than the market for the service;

of the test that issues of causation and countervailing effects arise. For example, the *NCC Guide to Part IIIA* explicitly states that when considering the public interest (paras 9.8-9.10 emphasis added):

... the Council must be satisfied that the overall costs of declaration do not outweigh the benefits of declaring services provided by bottlenecks or essential facilities. **The extent of these benefits depends on the likely effect of declaration on competition in related markets under [the promotion of competition limb] and the resultant positive effects or economic efficiency identified under [the public interest limb].**

A key public interest consideration is the net impact of declaration on economic efficiency.

...

It is important to avoid declaration where it may yield short term static gains in technical and allocative efficiency that constrain the realisation of longer term dynamic efficiency gains.

22. Therefore, although the concept of "promotion of competition" does not require proof of an actual increase in competition, it is possible to show that a decision would not be in the public interest if there would be no actual benefits (for example, *because there is no actual increase in competition*) or costs would outweigh benefits.
23. Therefore, Telecom submits that the Australian authorities are of little or no assistance when the words "to promote competition" are looked at in isolation as this would give this misleading impression that actual effects on competition are irrelevant to the Australian regimes. To the contrary, when looked at in context, the concepts of causation and *actual* effects on competition are all relevant in Australia too. TelstraClear's reasoning by snippet is therefore at best careless.

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- (b) that it would be uneconomical for anyone to develop another facility to provide the service;
 - (c) that the facility is of national significance, having regard to:
 - (i) the size of the facility; or
 - (ii) the importance of the facility to constitutional trade or commerce; or
 - (iii) the importance of the facility to the national economy;
 - (d) that access to the service can be provided without undue risk to human health or safety;
 - (e) that access to the service is not already the subject of an effective access regime;
 - (f) that access (or increased access) to the service would not be contrary to the public interest.

National Gas Code, s 1.9:

Subject to sections 1.4(a) and 1.10, the NCC must recommend that the Pipeline be Covered (either to the extent described, or to a greater or lesser extent than that described, in the application) if the NCC is satisfied of all of the following matters, and cannot recommend that the Pipeline be Covered, to any extent, if the NCC is not satisfied of one or more of the following matters:

- (a) That access (or increased access) to Services provided by means of the Pipeline would promote competition in at least one market (whether or not in Australia), other than the market for the Services provided by means of the Pipeline;
- (b) that it would be uneconomic for anyone to develop another Pipeline to provide the Services provided by means of the Pipeline;
- (c) that access (or increased access) to the Services provided by means of the Pipeline can be provided without undue risk to human health or safety; and
- (d) that access (or increased access) to the Services provided by means of the Pipeline would not be contrary to the public interest.

B. MARKET DEFINITION: SUBMISSIONS ON *PLASTIC CRATES*

Introduction

24. Telecom submits that its earlier submissions on market definition are supported by the recent decision in *Brambles New Zealand Limited v Commerce Commission* (High Court, Auckland, CIV 2115-03, 24 October 2003, O'Regan J and Kerrin M Vautier CMG) ("*Plastic Crates*").
25. In its 29 October 2003 submissions on product dimension (see *Telecom's response to the Commerce Commission's Draft Report*, 29 October 2003, paras 515 to 544), Telecom submitted that:
- (a) There will be continuing convergence of the assets used to provide data and voice services such that in the near future (and certainly within 5 years) DSL, TDM, Fibre, fixed wireless, mobile wireless and satellite will all offer high speed access over IP protocol.
 - (b) Very soon the present dichotomies between voice and data, and broadband and narrowband will be of historical relevance only and, instead, there will be a continuum of quality options and price constructs offered by multiple providers over different infrastructures.
 - (c) Therefore, by 2008 it will be inappropriate to separate local loop services, PDN services, voice, data, narrowband and broadband into separate product markets. Instead, it is appropriate to consider a single product market for high-speed packet based access for the provision of various telecommunications applications (including voice, video, internet gaming, data etc).

Plastic Crates

26. *Plastic Crates* was an appeal from the Commission's decision to decline clearance for the merger of two companies in the business of hiring plastic produce crates to fruit and vegetable growers, wholesalers and retailers (Decision 495, 21 March 2003). The issue in relation to market definition was whether the product dimension of the relevant market was limited to plastic crates or whether it also included disposable packaging, cardboard boxes in particular. The Court agreed that the wider market definition that included disposable packaging was preferable and made the following observations:
- (a) The Commission must take a commercial common sense approach to market definition;
 - (b) The SSNIP test used by the Commission to determine product substitutability is a useful analytical tool but is not determinative in itself. In each case the results of the SSNIP test must be tested against commercial reality, especially when there is a significant product differentiation and it is difficult to assess and compare the available data;
 - (c) Cost equivalence after a hypothetical price increase of 5% is not a prerequisite for substitutability. This is particularly so when products are highly differentiated and the more expensive option provides additional benefits. When considering whether such products are substitutable the overall "price-product-service packages" of each product must be compared.
27. The Court concluded that:

This was a case where there was significant product differentiation and therefore real difficulties in applying the SSNIP test. It is appropriate to make a

common sense assessment, based on the evidence before the Commission. Clearly, cardboard cartons and plastic crates are technical substitutes for most product lines, and both are being used in the product distribution chain at the moment.

Market definition

28. Telecom submits that the High Court's decision reflects a common sense observation about price and product differentiation in real world markets. As Klein and Wiley note:²

Product differentiation is the norm not just for the most mundane and apparently simple products, such as soft drinks, breakfast cereals, or athletic shoes. Consumers place different values on inherently subjective characteristics, such as taste, packaging, or product image of these goods. In addition, consumers will differ in their perceptions of product or service quality based on their past experience and particular relationship with a supplier's retailers, and other customer-specific factors. Apart from wheat and other bulk commodities, it is difficult to find many markets with truly fungible products along all dimensions of demand.

29. Applying this to these principles to the telecommunications markets over the time frame of the Commission's investigations, Telecom submits that (at least in the absence of unbundling):

- (a) By 2008 the distinction between narrowband and broadband will not be important per se. On the supply side, technological advancement and economies of scale will mean that consumers will have high speed access that will enable them to use a variety of IP-based applications, such as video-conferencing, internet gaming and exchange of voice and other types of data. Access will be by fixed line, wireless or satellite, depending on the technologies which different suppliers choose to invest in.³
- (b) On the demand side, customers will have a choice of different access packages, each with different functionality, quality service standards and pricing constructs. The customer will choose the appropriate package based on his or her requirements pay. For example, a relatively unsophisticated home user may only require high download speeds and voice over IP. In contrast, a small business may need these services as well as video-conferencing and the ability to upload large data files. The price of each consumer's access package will depend on its features and functionality.
- (c) The differentiated services available through the single access market is analogous to the differentiation present in almost all market today, from new cars, to clothes, to home entertainment products, to airline, stadium and cinema seating options.
- (d) The *Plastic Crates* decision supports Telecom's submission that there will be a single market for a number of differentiated telecommunications services. It requires the Commission to consider whether differentiated products and services are part of the same market as a matter of commercial reality. Where products are differentiated, the Commission must compare the overall "price-product-service package" of each to determine whether they are substitutable. This allows the Commission to take into account the fact that customers may be willing to pay more for a better product.

² Klein and Wiley Jr *Competitive price discrimination as antitrust justification for intellectual property refusals to deal* [2003] 70 ALJ 599, 609.

³ Competition in broadband provision and its implications for regulatory policy, DotEcon and Criterion Economics, October 2003, pages 82 to 95..

- (e) Telecom submits that the Commission must apply the reasoning in the *Plastic Crates* decision to its assessment of the market in its investigation into unbundling. As a matter of commercial reality, a customer's choice of package will depend on his or her needs and willingness to pay. More expensive packages will be substitutable for cheaper packages because they will offer customers more functionality. The continuum of differentiated telecommunications services will all be part of a single market for high-speed access for the provision of a variety of telecommunications services, including both voice and data services.

C. JURISDICTION TO REQUIRE A REFERENCE UNBUNDLING OFFER AND APPOINT AN INDEPENDENT REFEREE

Introduction

30. This section addresses TelstraClear's argument (29 October 2003, section 7) that the Commission should require Telecom to provide a Reference Unbundling Offer ("**RUO**") and appoint an independent party to facilitate implementation.

Jurisdictional Issues

31. Telecom submits that Telstraclear's proposals are outside the scope of the Commission's investigation. In particular, the proposed RUO and independent referee are:
- (a) outside the scope of the section 64 and Schedule 3 investigations;
 - (b) inconsistent with the processes provided for in the Act in relation to determining non-price terms through:
 - (i) bilateral negotiations between the parties as required under section 22(c);
 - (ii) failing (i), a determination by the Commission following an application by an access seeker or an access provider under section 20; and
 - (iii) outside of that process, the Telecommunications Industry Forum may, under Schedule 2 of the Act, prepare access codes (for approval by the Commission) which regulate implementation issues within the industry; and
 - (c) in relation to the independent referee, outside the Commission's jurisdiction as it has no power to direct the Forum or vest the proposed powers in a referee.
32. Telecom notes that the proposal is not part of the Draft Report, and Telecom requests the opportunity to make further submissions if the Commission intends to include any form of this proposal in its Final Report.