

## Memorandum

23 December 2004

To: Roger Kerr  
New Zealand Business Roundtable

Re: Regulation of Mobile Termination

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### Introduction

1. I have reviewed the Commerce Commission's *Schedule 3 Investigation into Regulation of Mobile Termination: Draft Report* (18 October 2004) and the 30 November 2004 submissions in response to this Draft Report.
2. You have asked me to comment upon the legal framework issues concerning wealth transfers. The Commission has concluded that, under the Telecommunications Act 2001, transfers of producer surplus through regulation should count as a benefit to end-users. The Commission advances two key reasons to support this conclusion. First, it is said that this approach is grounded in the Act: paragraph 61. Second, it is suggested that the scheme and context of the Act means that the Commission must explicitly address distributive issues: paragraph 60. The Commission takes the position that where there is limited competition, there may be monopoly rents which need to be driven out by regulation.
3. The decision whether or not to designate a mobile termination service is based upon the purpose statement considerations under sections 18 and 19 of the Telecommunications Act. A range of comparative and contextual arguments in relation to this purpose statement have been raised by various parties in response to the Draft Report. Against this background, I think it is helpful to explore:
  - 3.1 comparative purpose statements in other regulatory settings;
  - 3.2 the literal interpretation to sections 18 and 19 of the Telecommunications Act; and
  - 3.3 whether a purposive approach to these provisions leads to the same, or a different, conclusion.
4. From my discussion of these issues below, I develop the following key conclusions:
  - 4.1 There are three steps to be followed under section 19. First, regard must be had to the promotion of competition for the long-term benefit of end-users of telecommunications services. This inquiry requires a consideration of efficiencies. Second, if applicable, consideration must be given to additional matters set out in Schedule 1 regarding the application of section 18. Third, decision-makers must

ultimately apply the purpose statement considerations so as to give best effect to the long-term competition and efficiency considerations set out in section 18.

- 4.2 The Commission, itself, takes the position that Schedule 1 does not apply to this case. The proposed form of designation does not include any additional matters to be considered regarding section 18. It follows that the interpretation provisions relating to pricing principles (clauses 2 and 3 of Schedule 1) do not apply in relation to the decision whether or not to designate a mobile termination service.
- 4.3 The Commission seeks to rely upon some wider purposive argument that the form of the pricing principles under Schedule 1 supports the application of a distributional standard under the efficiency test which applies to the decision whether or not to designate a service. This approach is unsupported by the plain and ordinary meaning of section 19(b). Further, the interpretation the Commission seeks to place upon these pricing principles is inconsistent with section 18. In the case of such inconsistency, section 18 prevails (by virtue of the guiding principles set out in section 19(c)).
- 4.4 It follows in my opinion that the Commission's standard approach to wealth transfers under the Commerce Act applies to the Telecommunications Act setting. They are to be treated as neutral.

#### Comparative Purpose Statements

5. There are three comparative legislative settings which provide useful background.
6. The first setting is the general purpose statement under the Commerce Act, section 1A. This states that: "The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand". This purpose statement is not blind as to link between competition (as a process) and efficiency (as a goal): see *Gault on Commercial Law* CA1A.05. The link is further reinforced through section 3A which applies to situations where applications are made for authorisation on the grounds that the public benefits of a proposed merger or restrictive trade practice outweigh any detriments. Section 3A expressly provides that regard must be had to efficiencies in assessing net public benefit. Public benefit is a wide concept. The long-term benefits of consumers or end-users are considerations which fall within the concept of public benefit. It is in this legislative context that the High Court has affirmed the standard approach of the Commission that wealth transfers between consumers and producers are to be treated as neutral: *Air New Zealand and Qantas v Commerce Commission* (High Court, Auckland, CIV2003 404 6590, Judgment No 6) paragraphs 237 ff.
7. The second setting is the generic price control part of the Commerce Act, Part IV. These provisions are based on the old price control provisions of the 1975 Act. It is fair to say that they attracted no particular attention at the time the 1986 Act was under consideration. At that time price control was a relic of the past. Virtually all goods had been removed from the so-called positive list. Against this background, it is not surprising that these generic price control provisions do not provide a model legislative framework. The market power threshold for control is unduly low. Competition need only be limited or likely to be lessened. Assuming this threshold is met, the question is then whether control is "necessary or desirable" in the interests of acquirers or suppliers.
8. The third setting is the electricity lines business price control regime, which is found in Part 4A of the Commerce Act. Section 57E has different philosophical foundations. It sets out a multitude of goals, not all of which are potentially in harmony: the promotion of the efficient

operation of markets; the long-term benefit of consumers; the limitation of excessive profits; incentives to improve efficiency; and the requirement that efficiency gains be shared with consumers, including through lower prices.

9. I will return to the significance of this legislative background in the section below on purposive analysis.

#### Literal Interpretation

10. The purpose statements with which we are concerned are set out in sections 18 and 19 of the Telecommunications Act. There are three essential steps to be followed under section 19.
11. *First step:* consider the purpose statements set out in section 18. In deciding whether or not to designate, consideration must be given to whether this would promote competition for the long-term benefit of end-users. This task involves a consideration of efficiencies. I see a strong parallel between sections 1A and 3A of the Commerce Act and subsections 18(1) and (2) of the Telecommunications Act. I do not think that these provisions raise distributive issues. While public benefits may be more general than end-user or consumer benefits, it does not follow that neutrality is only intended in the case of public benefits. Indeed, the operation of a general rule ought to apply to the particular. Further the term end-user, which the Commission has interpreted to mean all ultimate consumers of telecommunications services, refers to an extensive class of persons in a range of different capacities. Consumers include, for example, producers and suppliers of factors of production. It follows that the long-term interests of consumers here are likely to be very close to the public benefit test considerations.
12. *Second step:* if applicable, regard is to be had to the additional matters set out in Schedule 1. Schedule 1 sets out designated access services, including all relevant details relating to the form of these services. The Commission seeks to rely upon definition sections in this Schedule to support its claim that the Telecommunications Act sets a distributive standard. The Commission says, in essence, that because subclauses 2 and 3 use cost-based access pricing principles (these subclauses relate to retail price minus avoided costs saved and Baumol-Willig pricing principles), the Act must overall involve a distributive purpose. For a number of reasons the Commission's approach is wrong:
  - 12.1 Section 19(b) anticipates that applicable matters in Schedule 1 will inform upon and be consistent with section 18 considerations. Section 19(b) is designed to further articulate the efficiency goals which designation may seek to achieve. This is evidenced by the additional matters relating to section 18 which are identified in the examples of interconnection with Telecom's fixed PSTN and national roaming. In applying the pricing principles relating to interconnection with the fixed PSTN the Commission is required to consider the efficiency of one-way traffic schemes. In the case of national roaming, Schedule 1 requires the Commission to focus upon the efficient and timely roll-out of a national cellular mobile network.
  - 12.2 If the additional matters that must be considered under Schedule 1 are not consistent with section 18, then they should be read down. I return to this point below.
  - 12.3 In the present case the Commission has stated in the Draft Report that there are no additional matters to be taken into account under sections 18: see page 116. Therefore, there is no reason here to read Schedule 1 considerations into the interpretation of sections 18 and 19.

- 12.4 Further, the Commission has erred here in attempting to read pricing principle definitions into its interpretation of sections 18 and 19. There are four reasons for this. First, pricing principles are not the anticipated subject matter of section 19(b). Second, in any event, the Commission refers to pricing principles here (under clauses 2 and 3) which are at variance with those which the Commission identifies as the intended interim and final pricing principles (namely benchmarking and TSLRIC). Third, even if the pricing principles referred to in clauses 2 and 3 were to apply, it does not follow that the transfer of wealth from producers to consumers should count as a benefit. The Commission does not set out its reasoning for saying that forward-looking cost-based pricing principles are based upon a notion of wealth transfer. Indeed such an assumption is, as I understand it, wrong as a matter of economics because such principles might be contemplated to, in certain circumstances, improve efficiency. Further, the Commission's approach appears to reject what Alfred Kahn has referred to as the "central policy prescription of economics", namely the equation of price and marginal cost for efficiency reasons.<sup>1</sup> Fourth, there is no basis to read into clauses 2 and 3 of Schedule 1 the proposition that wealth transfers from producers to consumers should be treated as a benefit.
13. *Third step:* finally, consideration must be given to what best gives effect to the purpose set out in section 18. I read section 19(c) to say that section 18 considerations will prevail in the event that there are any inconsistencies between section 18 and relevant applicable matters under Schedule 1.
14. It follows, in my opinion, that the Schedule 1 provisions upon which the Commission relies (paragraph 61) are not applicable. In any event, even if they are applicable, the manner in which the Commission seeks to apply them is in conflict with the long-term competition and efficiency goals of section 18. To say that the Telecommunications Act has a prevailing purpose to achieve cost-based pricing, and that this entitles the Commission to treat transfers of wealth from producers to consumers as benefit, stands in conflict with section 18. In these circumstances, section 19(c) resolves this issue in favour of the section 18 purpose statement considerations.

#### Purposive Approach

15. Is there, nonetheless, some underlying purpose to the Telecommunications Act which overrides this conclusion? The Commission suggests that this is the case, with reference to two key points. First, there is some philosophical basis to assume that the regulatory setting involves monopoly profits which will not be driven out by competition: paragraph 60. Therefore, distributive issues need to be addressed. Second, the legislative history is said to support the conclusion that, where there is limited competition, cost-based prices are to be applied: paragraph 63.
16. I do not read the legislative history to support the proposition that wealth transfers should be treated as benefits.
17. Both the Commission (Draft Report, paragraph 63) and other submitters (e.g. Telecom, paragraph 71 ff) quote various Ministerial, Commerce Committee and related statements. There is a vagueness to much of this. For example, the key passage which the Commission relies upon in paragraph 63 states that: "The Government's overall objective is to ensure delivery of cost-efficient, timely and innovative telecommunications service on an ongoing, fair and equitable basis to all existing and potential users." There is a clear efficiency theme here. What is fair and equitable will mean different things to different

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<sup>1</sup> Alfred E Kahn, The Economics of Regulation: Principles and Institutions, MIT Press, 1988 printing, 65/1.

people. Turning to the key statement of the Minister which is quoted at paragraph 72 of Telecom's submission,<sup>2</sup> I read this to support an efficiency goal direction. A contrary conclusion would inject an inconsistency into this statement. Overall, I read these statements as not supporting the Commission's claim that the Telecommunications Act has a goal of wealth transfer.

18. The actual legislative design is another issue. At the time the Telecommunications Act was under consideration, the mixture of previous regulatory approaches, as outlined above in paragraphs 6-8 was known. The Telecommunications Act is a hybrid of (a) the low market power threshold under generic Part IV, (b) a prevailing purpose statement under section 18 modelled on sections 1A and 3A of the Commerce Act and (c) the cross-reference to Schedule 1 in section 19(b) which, in my view, can only inform efficiency considerations in a manner consistent with section 18.
19. TelstraClear argue (paragraphs 183-84) that section 57E of the Commerce Act (relating to electricity lines businesses) supports the thesis that long-term benefits are achieved by wealth transfers. It seems to me that the reverse argument is more appropriate. If a universal distribution standard had been intended, then section 18 of the Telecommunications Act would have included a more explicit provision than section 57E(a) and (c) of the Commerce Act. Inferences can be drawn from the fact that it does not. Further, there is no provision in section 57E, similar to section 19(c), giving guidance to which considerations ought to prevail in the event of conflicting goals.
20. Accordingly, I do not think the legislative history disturbs the conclusion I have advanced regarding the literal interpretation of sections 18 and 19. The remaining matter for consideration is whether there is a regulatory exception to the Commission's standard approach, that wealth transfers ought to be treated as neutral.
21. I do not consider the distinction the Commission seeks to draw between control and competition as regulatory mechanisms is valid in the context of assessing long-term efficient outcomes: paragraph 60. The authorisation context under the Commerce Act involves an assessment of detriment resulting from a lessening of competition. This competitive harm (which may involve some element of monopoly rent) can be overcome by countervailing public benefits, based upon efficiency considerations. For analytical purposes, I see no material difference here between public benefits and consumer or end-user benefits, particularly where long-term interest is paramount. This point can be taken from the High Court's decision in the *Air New Zealand/Qantas* decision. The mere fact that the Court noted that public benefits may be broader than consumer benefits does not mean that neutrality is only intended for public benefit, as I have mentioned before. In undertaking this trade-off, the accepted methodology is not to assess benefits based upon distributional standards. Rather, as the High Court has determined in *Air New Zealand/Qantas*, it is the balancing of real resource impacts on the economy which best serves the long-term interests of consumers.
22. A further problem with the Commission's analysis here is the suggestion that there is a sound economic rationale for viewing regulation (as opposed to competition) as a mechanism to achieve wealth transfer. The error in this approach, from an economic perspective, is addressed in the submission of Dr Katz (paragraphs 47 ff).

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<sup>2</sup> "Most important, the purpose clause in Part 2, clause 18, has been brought into line with the purpose of the Commerce Act and that is a very, very important streamlining of this bill. It clarifies that consumer welfare is the overall objective of this bill. It also makes clear that competition is the primary basis for calculating that welfare. Of course, there are efficiency sub-tests, as there needs to be, and that is in line with the Commerce Act."

23. From a legal perspective, I also do not read the Telecommunications Act to represent a mandate that cost-based pricing be imposed across all aspects of the telecommunications markets, to drive out monopoly rents wherever they may occur, and that it therefore follows that this Act sets a distributive standard. The centrality of the section 18 purpose statement negates cost-based pricing from having any such overarching objective, application or impact.
24. Further, and in any event, the Commission's attempt to rely upon forward-looking cost-based pricing principles to support its wealth transfer approach is unsupported by a proper formulation and application of such principles. Such pricing is used under incentive regulation purely to induce efficiency in certain circumstances.<sup>3</sup>

### Summary

25. The Commission's conclusion that, under the Telecommunications Act, transfers of producer surplus through regulation should count as a benefit to end-users is wrong for the following reasons:
  - 25.1 The legislative scheme of sections 18 and 19 of the Telecommunications Act is based upon sections 1A and 3A of the Commerce Act. It is well established under the Commerce Act jurisprudence which applies to these provisions that wealth transfers are to be treated as neutral in assessing the long-term benefits of competition. It follows that the goals set out in section 18 do not involve wealth transfers.
  - 25.2 The cross-reference in section 19(b) to Schedule 1 relates to matters which are intended to inform upon and be consistent with the goals of competition and efficiency, as set out in section 18.
  - 25.3 If any of the goals in Schedule 1 are in conflict with section 18, the section 18 goals will prevail.
  - 25.4 The Commission has, itself, stated that there are no additional matters which must be taken into account under Schedule 1.
  - 25.5 It follows, for these reasons, that the Commission is wrong to assert that definitions in Schedule 1 relating to pricing principles should form the basis for the view that transfers of producer surplus should count as benefits to end-users.
  - 25.6 In any event, the Commission misconstrues the pricing principles definitions in clauses 2 and 3 of Schedule 1. A proper formulation and application of forward-looking cost-based pricing principles does not accord with the Commission's rationale that the goal of such pricing principles is to transfer wealth from producers. Further, a proper interpretation of these provisions does not support the proposition that wealth transfers from producers to consumers should be treated as a benefit.

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<sup>3</sup> See also Kahn, *op cit*, 85/1. Kahn acknowledges that pricing at short-run marginal cost (SRMC) may fail to allow the public utility to recover all its capital costs and concludes that "the practically achievable benchmark for efficient pricing is more likely to be a type of average long-run incremental cost, computed for a large, expected incremental block of sales, instead of SRMC, estimated for a single additional sale." Kahn is referring here to cost-based pricing for efficiency reasons rather than for distributional reasons.