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# Designation of Mobile Termination Services

Some comments on the submissions of Telecom,  
Vodafone, and Professor Michael Katz.

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*Prepared for TelstraClear*

*by*

*Geoff Bertram*

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The logo for Simon Terry Associates features a stylized graphic of three curved, overlapping lines above the company name. The text "Simon Terry Associates" is written in a serif font, with the word "Simon" in a smaller size than "Terry Associates".  
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## 1. Introduction

I have been asked by TelstraClear to prepare a review of economic issues relating to the type of cost-benefit test the Commerce Commission should apply when considering whether to recommend designation of mobile termination charges under Part 2 of the Telecommunication Act 2001. In particular, I have been asked for a report which

1. Details the economic justification for a consumer-welfare approach;
2. Critiques the arguments of Vodafone and Telecom (and their consultants, notably Professor Michael Katz) on this matter.

I have previously reported on the general issues surrounding the public benefit test and the consumer welfare test, in material prepared for TelstraClear and submitted to the Commerce Commission in the context of the 2003 Local Loop Unbundling inquiry<sup>1</sup>.

In section 5 of my 2003 report I discussed at some length the role of wealth transfers in cost-benefit analysis, and this issue is again central to the outcome of the mobile-termination hearings. Disappointingly, Telecom has again pursued an approach to this question that is highly misleading, and this stance renders irrelevant much of its material.

In the sections which follow, I shall

- Review the internal logic of the so-called “total surplus standard” on which Telecom has relied heavily in its submissions, and of the “consumer welfare standard” adopted by the Commission in this case;
- Clarify the correct economic approach to distributional matters within a public-cost-benefit analysis, and review some key authorities in the economics literature to show that my approach is recognised as correct;
- Comment on the interpretation of relevant sections of the Commerce Act 1986 and the Telecommunications Act 2001 from the perspective of economic theory;
- Explain why I believe that the Commission has taken the appropriate position with respect to wealth transfers in its draft determination, and
- Set out a detailed commentary on the submissions of Telecom and Vodafone, and on the evidence of Professor Katz.

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<sup>1</sup> Geoff Bertram, *Unbundling the Local loop in New Zealand: Some Economic Issues Raised by Telecom’s Evidence*, Wellington: Simon Terry Associates, November 2003.

## **2. The Treatment of Transfers in Cost-Benefit Analysis**

### **2.1 General Remarks**

From the standpoint of economic theory, the issue of whether a cost-benefit analysis should take account of wealth transfers, and if so, how, is not something that can be resolved by appeal to any general principle. When analysis is undertaken from the standpoint of a particular group (e.g. consumers or end-users) then wealth transfers to and from that group have a direct impact on its welfare, and so will be included in the calculation of the group's net benefit. This is the approach taken by the Commission when evaluating the likely effects of price controls under s.52 of the Commerce Act 1986 and of designation under Part 2 of the Telecommunications Act 2001. I consider that the Commission is correct in adopting a consumer-welfare criterion in these cases, and hence its inclusion of rent transfers as a benefit of control is absolutely appropriate.

When the analysis is from the standpoint of society as a whole (what is sometimes described as a public benefit analysis), transfers from one group to another within the New Zealand population will leave the aggregate monetary wealth of the community unchanged, and may be set aside by the analyst, provided that there are considered to be no spillover effects<sup>2</sup> from the transfers to total social welfare, and no distortionary effects on resource allocation associated with the transfer. A general practice of treating transfers as having a zero net public-welfare effect has been adopted by the Commission in its consideration of authorisations for restrictive trade practices, mergers and takeovers, under sections 61 and 67 of the Commerce Act 1986. This approach has recently been supported in the merger context by the High Court in *Air New Zealand and Qantas v. Commerce Commission & Ors* (unreported, 17 September 2004).

As the Court noted in that judgment, “the words ‘benefit to the public’ remain intact; the term ‘public’ is intentionally broader than ‘consumers’; and an efficiency gain that benefits producers is still a benefit to the public.” This points to the existence of two separate tests within the Commerce Act, one broad (the public benefit test) and one narrower (the consumer welfare test).

### **2.2 Three Economic Standards: Total Surplus, Balanced Weights, and Consumer Welfare**

The flow chart on the next page shows the decision tree faced by a cost-benefit analyst involved in various types of hearings under the Commerce Act and the Telecommunications Act. There are two starting points, both of which are covered by the

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<sup>2</sup> “Spillovers” here refers to externalities generated by the transfer of wealth from consumers to producers, such that individuals or groups not themselves participating directly in the particular transaction experience effects on their welfare.

purpose statements of the two Acts. One starting point is end-user or acquirer-focused, and leads to a result that shows the net benefits for that target group. The other starting point involves the issue of public benefit rather than end-user benefit, and leads to either a total-surplus-standard result, or a balanced-weights calculation.

In the context of designation under Part 2 of the Telecommunications Act 2001, the statute requires the Commission to focus on the welfare of end-users. The cost benefit analysis is therefore not a public-benefit one, and the issue of whether to adopt the total surplus standard consequently does not arise. All of those passages in Telecom's submission which rely upon "the merger context" are automatically irrelevant to inquiries under Part 2 of the Telecommunications Act and Part IV of the Commerce Act. This applies in particular to Telecom's paragraphs 55, 62, 63, and 64, all of which explicitly deal with issues relating to the analysis of authorisation proposals under Part V of the Commerce Act 1986. It also applies to most of the remainder of Telecom's discussion of the appropriate treatment of transfers, which implicitly is located within a public-benefit rather than consumer-welfare criterion of net benefit. Very little of Telecom's discussion of wealth transfers is related to the particular context of designation under Part 2 of the Telecommunications Act 2001.

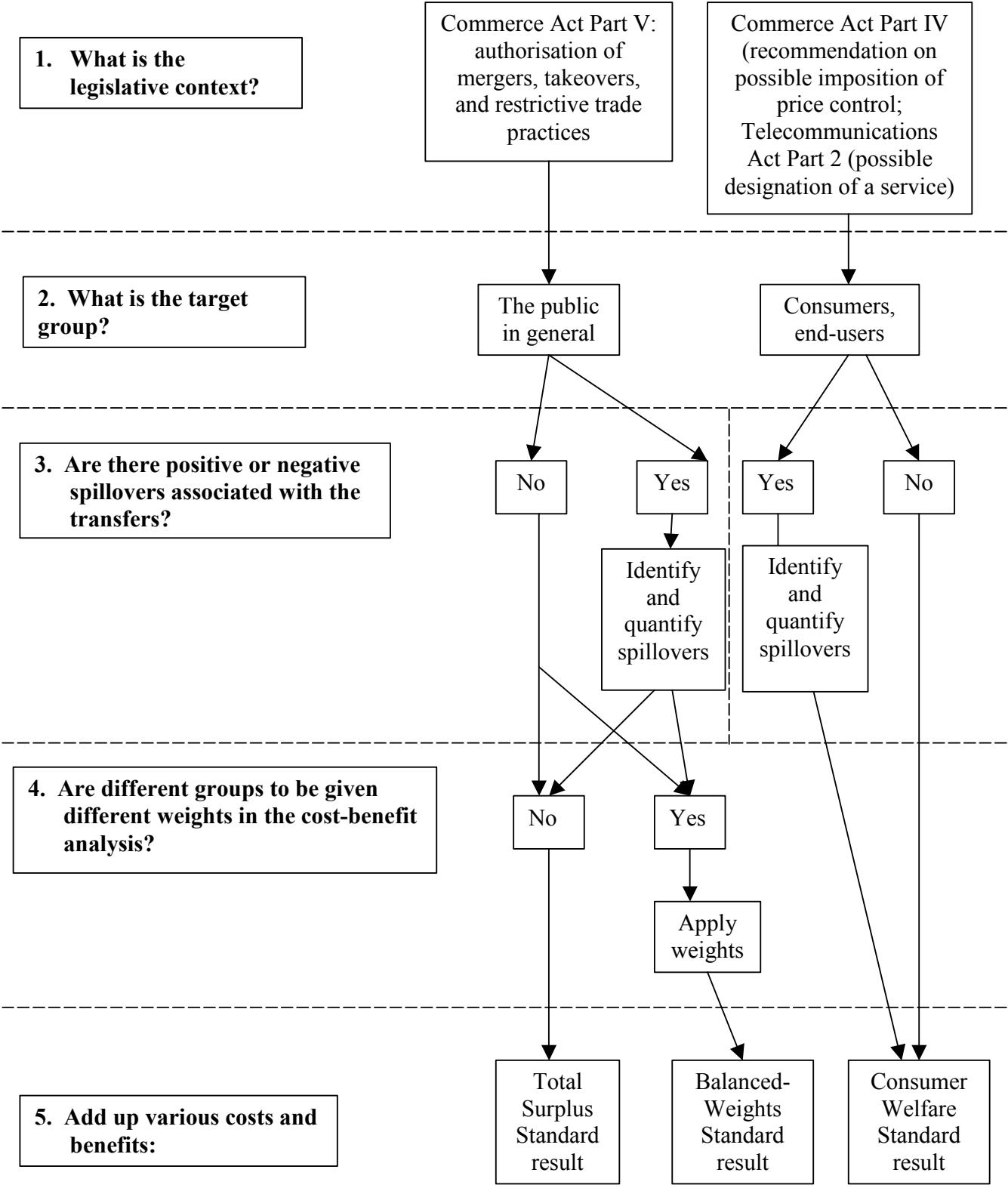
The so-called "total surplus standard" is a set of simplifying assumptions sometimes used in evaluating the net public (social) benefit expected to result from some change. The most important of these working assumptions is that the analyst can treat all transfers as having a net social impact of zero, which removes the need to evaluate them in detail. The standard is relevant only in the context of public-benefit-focused analysis and, in that context, only when there are no spillover effects from the transfers.

As the flow-chart shows, a public-benefits analysis does not necessarily entail adoption of the total surplus standard. The alternative approach, which assigns welfare weights to the various groups encompassed by the analysis, is commonly encountered overseas. In Canada, for example, the Federal Court decision in *Propane*<sup>3</sup> has made it mandatory for the Competition Tribunal to adopt a balanced weights standard, and has barred use of the total surplus standard approach.

It is important to note also that although the total surplus standard ignores transfers, in principle at least it ought to include consideration of spillovers (such as distorted economy-wide price relativities leading to distortions in economic structure). In principle, also, a total-surplus-standard analysis ought to check for rent-seeking (see below) and include its quantified impact in the analysis.

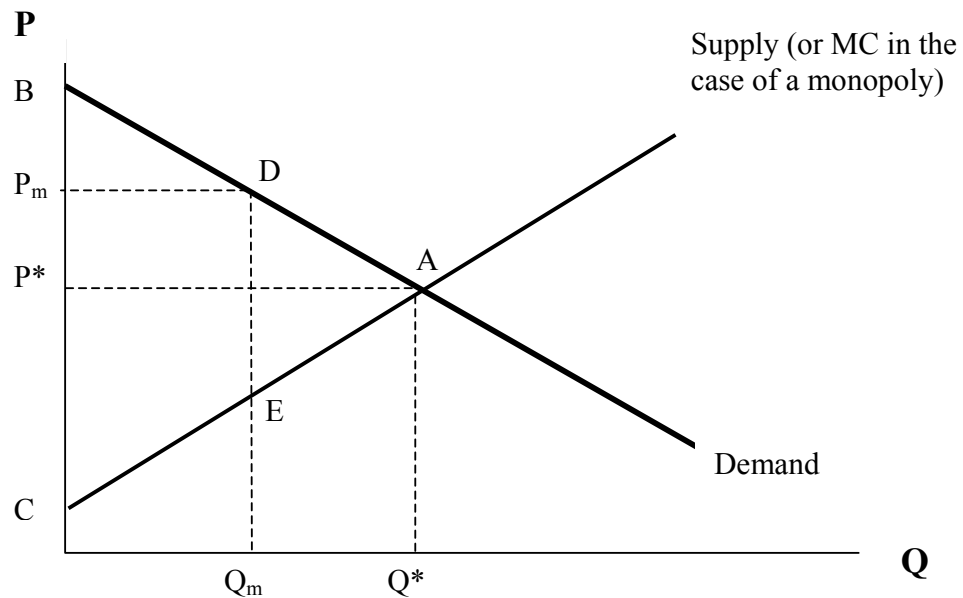
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<sup>3</sup> *Canada (Commissioner of Competition) v. Superior Propane* 2003 FCA 5.





In a world where regulation was costless, the various standards would all agree on the ideal point to which regulation should push the relevant market. Figure 1 below shows the standard diagram for a market. The social optimum is at price of  $P^*$  and quantity of  $Q^*$ . At that point, not only is consumer surplus maximized (the triangle  $ABP^*$ ) but simultaneously the total surplus (consumer surplus plus producer surplus) is maximized also – the area  $ABP^* + ACP^* = ABC$ .



With higher price  $P_m > P^*$ , and quantity  $Q_m < Q^*$ , both consumer surplus  $DBP_m$  and total surplus  $DBCE$  are reduced.

Thus the two standards coincide with respect to the optimal configuration for the market, namely the competitive price and quantity. The difference between them is only in the size of the gain from moving to this optimal position. The consumer welfare standard counts as a benefit of regulation the full amount of monopoly rent transferred back to consumers; hence the rectangle of rent transfers enters as a net gain. (The same result is obtained under the total surplus standard if all rent is wasted on unproductive rent-seeking.) In Figure 1, the consumer welfare standard measures the gain from controlling price to  $P^*$  as the area  $ADP_mP^*$ .

The total surplus standard measures the net increase in surplus (benefit from regulation) as the triangle  $ADE$ . The gain in consumer surplus will generally be larger than the increase in total surplus, which means that the consumer welfare standard will record a stronger welfare gain from regulation than the total surplus standard.

A natural consequence of this is that a firm with market power which is engaged in a strategic interaction with a regulator will generally prefer to see the total surplus standard used, because of the smaller gain from regulation and hence the greater chance of having the case for regulation overturned by other considerations such as the cost of regulation itself.

In New Zealand the legislative framework is generally clear in dictating, for each type of possible regulatory intervention, the welfare test to be used, at least with respect to the public-benefit/consumer-welfare dichotomy. The legislation is silent on whether a public-benefit analysis ought to adopt the total surplus standard or the balanced weights standard, and consequently it is up to the regulatory authorities to decide whether to treat all groups equally, or to weight certain groups more highly than others.

Internationally, most jurisdictions have competition laws in place that treat hold-up of consumers to extract monopoly rents as an illegitimate expropriation of consumer wealth, to be treated accordingly as akin to theft. From this perspective, the consumer welfare standard is appropriate, since it does not recognise as a relevant “detriment” the requirement on the monopolist to disgorge the gains from exploitation of its customers.

This is particularly the case in the USA where, as Professor Katz reminds us in paragraph [56] of his evidence to this hearing, “Federal competition policy statutes largely promulgate a consumer welfare standard, which is very similar to the concept of long-term end-user benefits.” As Professor Katz goes on to note, “In applying this standard, U.S. competition policy does not pursue enforcement actions simply because they would transfer wealth to consumers.....U.S. competition policy focuses on blocking actions that would harm competition. It does so because harm to competition would be expected to lead to harm for consumers.”

### **2.3 A Review of the Welfare Impacts of Transfers**

Because of the high profile given to transfers in Telecom’s submissions, it may be helpful to spend some time exploring the ground onto which Telecom seeks to draw the Commission. In doing this I should not be interpreted as giving any credence whatever to Telecom’s insistence that a total-surplus-standard cost-benefit model ought to be applied to the issue of mobile termination. As already noted, in my view the statutory framework is absolutely clear in prescribing a consumer welfare analysis, and Telecom’s and Vodafone’s attempts to force the Commission into using an alternative framework drawn from the merger-authorisation context in the Commerce Act are altogether misconceived.

I begin with an example drawn from the merger context, specifically a merger to monopoly – a change which requires authorisation by the Commission under s.67 of the

Commerce Act 1986. Section 67(3)(b) of the Act explicitly requires that the Commission must be “satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted”. Later I shall turn to the case of price control in order to see where a public-benefit test might lead, were this area of regulation not explicitly identified in the legislation as a matter of consumer welfare.

**Figure 1: Williamson’s diagram for his “Naïve Model”**

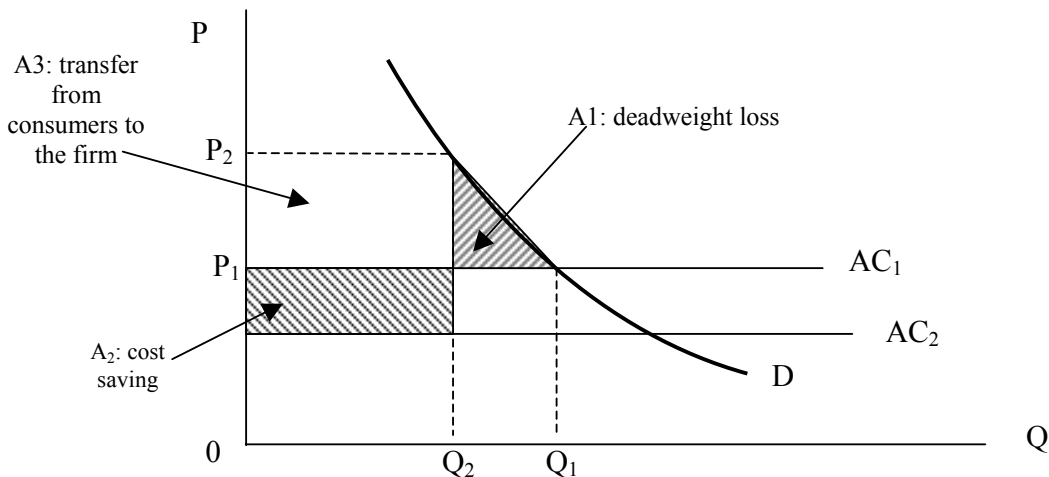


Figure 1 reproduces a famous diagram from Williamson<sup>4</sup> in which two firms propose merger to monopoly. In the status quo (the counterfactual), average cost for both firms is  $AC_1$ , market price is  $p_1$  (the long-run competitive price), and there is zero economic profit<sup>5</sup>. The merger is predicted to reduce costs to  $AC_2$  and drive the price up to  $p_2$  as the merged entity exercises its new-found market power.<sup>6</sup>

Several effects of the merger can be quantified by measuring relevant areas on the diagram. A lower-bound estimate of direct losses of allocative efficiency is the area A1; cost savings due to improved productive efficiency are area A2; and the transfer of monopoly rent from consumers to the firm is area A3. The sum of producer surplus and consumer surplus (the “total surplus”) changes by the amount  $A2 - A1$ , which may be positive or negative.

The first two effects are straightforward to quantify, but the third presents a problem from the economic point of view. Because it is a zero-sum transfer from one group of the

<sup>4</sup> Williamson, O.E., “Economies a an Antitrust Defence: the Welfare Tradeoffs”, *American Economic Review* 58: 18-36, 1968.

<sup>5</sup> Pre-merger, thus, the firms are playing a Bertrand game, competing on price.

<sup>6</sup> There is assumed to be no price-cap regulation imposed at the time of merger; otherwise price could be held at  $p_1$  which would enable the firm to benefit from productivity gains due to the merger, but not from increased market power.

population to another, it has no direct effect on the total amount of consumer plus producer surplus. But it obviously has potential welfare implications that must be addressed. To quantify the effects of a transfer the analyst must (i) estimate the social value of the increase in profits of the monopoly, relative to the counterfactual; (ii) estimate the full social cost of the extraction of wealth from captive consumers who have been held-up by the newly powerful firm (including spillovers); and (iii) find the net social effect.

The “total surplus standard” is a rule of thumb that simply assumes the net effect of the transfer to be zero, in which case the social effects of the merger are merely the change in total surplus,  $(A2 - A1)$ .

Williamson dealt with the social valuation of rent transfers as follows. He was clear that his case for consideration of an efficiencies defence for mergers “does not of course mean that the mere existence of economies is sufficient to justify a merger” (1968 p.34). His case was that where net economies (a gain in total surplus) can be argued to arise, this should “give the antitrust authorities pause before disallowing ... a merger” (1968 p.34), and that allocative efficiency ought to be part of antitrust hearings.

The pure total-surplus approach (treating transfers as net-zero) was characterised by Williamson as “naïve”, and his reasons for so labeling it are set out in some detail in the main body of his 1968 paper. Of the various assumptions and qualifications he discusses, two are of particular relevance here.

First, Williamson’s partial-equilibrium approach explicitly makes the assumption that “social and private costs are ... identical (externalities ... are... assumed to be zero)” (1968 p.22 footnote 4). The resulting qualifications which he acknowledges are potentially wide-ranging in their implications:

- “By isolating one sector from the rest of the economy, [the partial-equilibrium analysis on which the 1968 paper rests] fails to examine interactions between sectors. Certain economic effects may therefore go undetected, and occasionally behaviour which appears to yield net economic benefits in a partial equilibrium analysis will result in net losses when investigated in a general equilibrium context” (p.23).
- “It is...vital to consider not merely the market power effects of any single merger taken in isolation, but whether the merger is representative of a trend. If a series of such mergers can reasonably be expected, the judgment of whether to permit any given combination should properly be cast in an industry context – in which case the anticipated economy and market power effects throughout the industry should be examined.” (p.26). [Emphasis added]
- “The political implications of the control over wealth involve a judgment of how the quality of life in a democracy is affected by size disparities. The latter is less

easily (or even appropriately) expressed in efficiency terms. The issue is nevertheless important” (p.29).

Second, Williamson deals in some detail with the issue of how transfers between consumers and producers should be evaluated. “On the resource allocation criteria for judging welfare effects ... the distribution of these profits becomes a matter of indifference. For specific welfare valuations, however, we might not always wish to regard consumer and producer interests symmetrically – although since, arguably, antitrust is an activity better suited to promote allocative efficiency than income distribution objectives (the latter falling more clearly within the province of taxation, expenditure and transfer payment activities), such income distribution adjustments might routinely be suppressed. If they are not, the tradeoff between efficiency gains and distributive losses needs explicitly to be expressed. Thus, while economies would remain a defense, any undesirable income distribution effects associated with market power would be counted against the merger rather than enter neutrally as the naïve model implies” (pp.27-28). [Emphasis added]

The point is reiterated in Williamson’s 1977 paper<sup>7</sup> (p.711): “a product-specific claim that user and producer interests should be weighted unequally as they relate to the region [A3 in Figure 2 above] does not vitiate the partial equilibrium model. It merely requires that the appropriate weights be specified. To the extent that purchaser interests are given greater weight than supplier interests, the economies burden is increased, *ceteris paribus*.”

The above qualifications go to the heart of the issue. Stripping away Williamson’s “qualifications” converts his model into a simple total-surplus-standard, but exploring them directly opens the way to either a consumer welfare standard (which gives a weight of one to consumers’ interests and zero to the monopolist’s) or a balancing-weights standard (which assigns weights between zero and one to each identifiable group affected by the transfers). Such exploration does not involve any necessary switch from “objective” to “subjective” reasoning, nor from economic to non-economic analysis, nor from the realm of efficiency to the realm of “fairness”. Nor do economists need immediately to declare their discipline at a loss to illuminate the issues surrounding transfers.

### *Harberger*

Outright advocacy of the total surplus standard is found in an influential 1971 paper by Harberger<sup>8</sup> which he described as “an open letter to the profession”, pleading for the adoption of three ad-hoc assumptions to be used in applied welfare economics. The third

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<sup>7</sup> Williamson, O.E., “Economies as an Antitrust Defence Revisited”, *University of Pennsylvania Law Review* 125(4): 699-732, April 1977.

<sup>8</sup> Harberger, A.C., “Three Postulates for Applied Welfare Economics: An Interpretive Essay”, *Journal of Economic Literature* 9: 785-797, 1971.

of these was that (p.785) “when evaluating the net benefits or costs of a given action (project, program, or policy), the costs and benefits accruing to each member of the relevant group (e.g. a nation) should normally be added without regard to the individual(s) to whom they accrue”.

Harberger’s aim was simply pragmatic: to encourage economic analysts to press ahead with the task of estimating empirically the consequences of various alternatives, while setting aside difficult and complex issues which might otherwise bog the analysis down. The arguments he advanced for assuming income redistribution to be one of those issues which could appropriately be thus set aside are worth traversing in some detail.

Harberger’s first and most fundamental line of argument was that economists have nothing to say on distributional matters that cannot be said equally well by laypersons: (p.785):

“... any program or project that is subjected to applied-welfare-economic analysis is likely to have characteristics upon which the economist as such is not professionally qualified to pronounce, and about which one economist is not professionally qualified to check the opinion of another. These elements – which surely include the income-distributional and national-defense aspects of any project or program, and probably its natural-beauty aspect as well – **may be exceedingly important, perhaps even the dominant factors governing any policy decision**, but they are not a part of that package of expertise that distinguishes the professional economist from the rest of humanity. And that is why we cannot expect to reach a professional consensus concerning them. If we are to take a (hopefully justified) professional pride in our work, we must also have the modesty and honesty not to claim for our profession more than we are particularly qualified to deliver.” [Emphasis added.]

Because economists have (in Harberger’s view) no discipline-based ability to resolve distributional matters, and because Harberger was expressly motivated by (p.786) “the merit of attaining something like a consensus, and the possibility of helping to induce some movement toward that end”, his proposal to ignore distributional changes is entirely a matter of convenience and convention in conducting empirical research, and has no theoretical basis at all.

Harberger did not argue that economics in some way offers a definitive answer to the evaluation of the redistributive effects of any “program, project or policy”. What he argued was that such effects are quite likely to be so important as to dominate the final decision, but that economists have nothing to contribute professionally to that aspect of the decision. Nowhere did he suggest that economists should press upon policymakers a professional view that distributive effects are unimportant, or that policymakers ought to

ignore distributive matters simply because economists had no means of reaching a professional consensus. Harberger's argument is for economists to stand back and allow others to reach informed judgments on matters of redistribution. He certainly did not propose that policymakers ought to be silent on distribution simply because, as he saw it, economists have nothing to say. Nor should policymakers treat transfers as economically neutral simply on the word of one faction within the economics profession – which, as Harberger pointed out, is profoundly divided on such matters.

Later in the paper Harberger (1971 p.787) acknowledges that distributional weights may be attached to the welfare of different groups. The passage in which he does so is worth quoting at length:

National income and NNP are, in a very real sense, measures of welfare under certain assumptions, but only to a first order of approximation. No one would deny that many other factors are also important – the strength of the social fabric, the quality of life, **and certainly the issue of to whom the income accrues** – but it is not feasible to build these into a national-income measure. Hypothetically, one might contemplate a national income measure incorporating 'distributional weights', but two obstacles stand in its way: first, the impossibility of achieving a consensus with regard to the weights, and second, the fact that most of the data from which the national accounts are constructed are aggregates in the first place, and do not distinguish the individuals or groups whose dollars they represent. **Giving equal weight to all dollars of income is mathematically the simplest rule**, and our data come that way in any event.

Harberger's case for treating all dollars as equal thus rests upon a purely pragmatic quest for the mathematically simplest route to a welfare measure. He neither asserts that in principle all dollars are equal, nor does he argue for decision makers to proceed on the basis of that assumption. His position is that the economist's evaluation should stop when it reaches the boundaries of the disciplinary consensus, and that from that point on, the decision-making process must confront the distributional issue without help from economists.

With economic analysis thus muzzled on distributional weights, Harberger (1971 p.794) then advanced what looks to be the claim frequently encountered in submissions to the Commerce Commission in recent hearings:

...**unless there are distortions**, the benefits to demanders of a fall in price are cancelled by the costs to suppliers, and vice versa in the case of a rise in price. [Emphasis added]

This again is not a matter of principle – it is simply and solely a rule of thumb to use when implementing the entirely-pragmatic (“mathematically simplest”) research programme to which economists are equipped to contribute, in Harberger’s view.

Even with that strong qualification, it is worth looking more closely at the caveat “unless there are distortions” in the passage quoted above. On p.794 Harberger identifies what he means by “distortions”. His list is

- 1) Taxes
- 2) “Monopoly profits, in the sense of any return (above the normal earnings of capital) that is obtained as a consequence of artificially restricting sales to a point where price exceeds marginal cost **should also clearly be included**” [Emphasis added]
- 3) “The excess of price over marginal revenue in any external market in which the society in question has monopoly power”
- (4) and (5) “are simply counterparts of (2) and (3) for the case of monopsony”
- (6) “Externalities of all kinds”

Not only, therefore, does Harberger (1971) provide no warrant in principle for treating transfers as neutral in the final decision-making process; he explicitly rules out such an approach in the presence of “distortions”, which include monopoly profits.

For Harberger’s proposed convention of setting no distributional weights to be coherent, it is immediately obvious that he must be assuming the existence of some other, complementary, policy or procedure by means of which decision-makers can take account of, and correct for, distortions including monopoly profits. Indeed, on p.795 he sets out precisely a proposal along these lines, for “a set of policies that characterizes a full optimum”:

This entails no more than introducing taxes, subsidies, or **other policies to neutralize distortions (e.g. monopoly, pollution)** that would otherwise exist, so that the consolidated  $D_i$  [*Distortions*] affecting each activity are all zero, and raising government revenue by taxes that are truly neutral... [Emphasis added]

It is, thus, only where policies have been implemented which correct any monopolistic distortions of price, that Harberger pleads for treating transfers as neutral. The logic of his paper does not argue that decision-makers ought to disregard transfers – it argues that (i) if “distortions” are absent, decision-makers ought not to ask economists for advice on evaluating transfers; and (ii) when distortions are present, adopting the pragmatic zero-net-benefit approach to transfers will produce a seriously flawed estimate.

Whether transfers matter or not is an issue to be confronted in each case as it arises. A decision-maker operating in a policy environment that leaves distortions such as monopoly profits untouched should be especially sceptical of any economic advice to ignore transfers, because a sub-optimal policy environment can lead to gross distortions if Harberger's rules of thumb, designed to pass muster in an undistorted world, are slavishly followed.

### *Little and Mirrlees*

Similar arguments are found in the OECD's cost-benefit manual by Little and Mirrlees (1974), Chapter 2, pp.18-22:

...[P]rofits are an almost essential signalling mechanism for guiding decentralized investment decisions – but they may or may not be a *good* signalling mechanism. They are good only if expenditures closely measure social costs and receipts closely measure social benefits..... The essence of a cost-benefit analysis is that it does *not* accept that actual receipts adequately measure social benefits, and actual expenditures social costs. But it does accept that actual receipts and expenditures can be suitably adjusted so that the difference between them, which is therefore very closely analogous to ordinary profit, will properly reflect the social gain. [Emphasis in original]

...

Surely a dollar's worth of consumption by a rich man, and a poor man, cannot both be reckoned as a benefit of \$1 to society? Yet the view that profits are the best measure of benefit presupposes that it is so reckoned. We are now hard up against one of the basic theoretical and practical problems of economics. .... Here we shall merely record that the profitability measure treats a dollar's worth of consumption as equally beneficial no matter who gets it. Consequently profitability will be a good measure of the net social benefit (i.e. the social profit) of a project **only if, in the case under consideration, neglect of income distribution can be justified.** [Emphasis added]

### *Baumol*

An example of the dangers of the separability argument (that distributional matters are unconnected with resource-allocation matters, and should be dealt with by separate branches of government) is the case of the Baumol-Willig Rule, which was advocated

some years ago by Telecom as their preferred methodology to set interconnection prices for its fixed PSTN. As became apparent, the rule possessed attractive efficiency properties but left untouched any prevailing monopoly profits. The chief architect of the Rule, Professor William Baumol, was completely open about this. Giving evidence before the High Court in 1992 in *Clear v Telecom*, he pointed out that: "... the input pricing rule is there for one purpose and it does not serve other purposes. It does not cure AIDS or baldness, it does not get rid of business cycles and it is not in my view the proper instrument to get rid of monopoly profits." (Quoted in Farmer 1993<sup>9</sup> p.26.).

After his participation in the New Zealand case, Baumol pointed out in a number of papers that in formulating the Rule, he had assumed away the problem of monopoly rents at the outset. In common with many economists familiar with US conditions, Baumol took it for granted that a regulatory machinery was in place to control monopoly profiteering, so that in setting an interconnection charge the issue was purely to find the most productively-efficient price. Translated to a New Zealand context with no regulator in place (at that time), and no price control (other than a limited form in the Kiwi Share Obligation), the Rule became a shield for monopoly profits. As Baumol subsequently pointed out<sup>10</sup>, "the permissibility of allowing the incumbent firm to recover monopoly rents in the opportunity-cost component of its interconnection charge ... will be a lesser concern in US regulatory proceedings [than in New Zealand] because the prices monopolists can charge for their end products are regulated".

## 2.4 Controlling Monopoly Prices

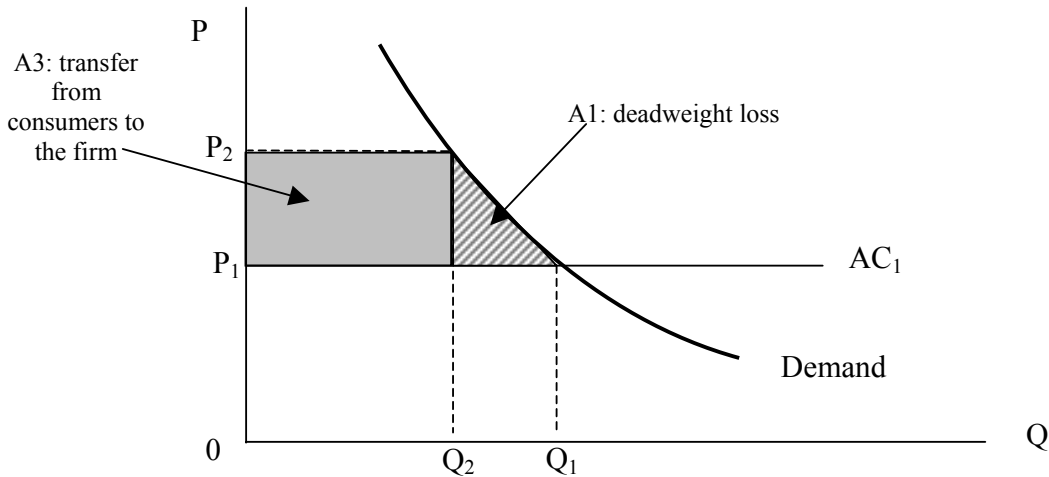
I turn now to the situation where the Commission is considering whether to recommend regulation of an existing supplier with market power (such as Telecom). For ease of comparison, I modify the Williamson diagram from Figure 1 to obtain Figure 2.

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<sup>9</sup> Farmer, J., "Transition from Protected Monopoly to Competition: the New Zealand Experiment", in *Symposium on Public Utilities: the New Environment*, Institute of Policy Studies, Victoria University of Wellington, 2003.)

<sup>10</sup> Baumol, W.J. and Sidak, G.J. (1995), "The Pricing of Inputs Sold to Competitors: Rejoinder and Epilogue", *Yale Journal on Regulation* 12(1): 177-186, Winter, abstract.

**Figure 2: Regulation of a Firm with Market Power**



Here the price is initially at  $P_2$  and quantity is  $Q_2$ . The regulator faces the decision whether to impose a price cap at  $P_1$ . Costs are assumed to remain unchanged, but the price reduction will increase total surplus by eliminating the deadweight loss A1. It will also eliminate monopoly rent A3 by transferring this amount to consumers..

The total surplus standard would recognize as a social gain only the area A1. Because this gain is realized only through the intervention of a regulator, any social costs of regulation are subtracted from A1 to yield the net gain or loss. This in essence is the procedure which Telecom has urged the Commission to adopt in relation to mobile termination charges.

Economic theory, however, points to two other matters that ought not to be overlooked even in a public-benefit analysis. The first is that leaving intact the prevailing monopolistic price distortion in this sector has economy-wide ramifications, and these would have to be quantified to determine whether the cost of regulation is greater or less than the overall social gain from improved relative-price signals and reduced diversion (expropriation) of wealth. A calculation which sets the deadweight loss triangle A1 against the estimated cost of regulation will be biased against regulation because it will fail to factor-in the economy-wide benefits of removing price distortions from an important market. This is especially true when the sector is one which, like telecommunications, supplies a key input for a large number of other sectors.

Secondly, once the monopoly firm is engaged in a strategic contest with a regulator, there is an important additional element of allocative inefficiency to be factored in: the deadweight cost to the economy of rent-seeking behaviour.

I discuss these two matters in the two subsections below.

*Dynamic Efficiency implications of transfers 1: the Monopoly-Growth Nexus*

Simplistic advocates of the total surplus standard (including Telecom's submission to this hearing) often make the bald assertion that wealth transfers have no efficiency implications. In fact there is a large economics literature on the ways in which monopoly rents, and the distortion of markets that they represent, are expected to have a negative impact on both allocative and dynamic efficiency.

One of these areas of economic theory deals with the negative impact on incentives and investment of the expropriation of the wealth of individuals and/or firms by firms with market power. Hall and Jones, in a celebrated econometric study of cross-country productivity differentials, argue that<sup>11</sup>

differences in capital accumulation, productivity, and therefore output per worker are fundamentally related to differences in social infrastructure across countries. By social infrastructure we mean the institutions and government policies that determine the economic environment within which individuals accumulate skills, and firms accumulate capital and produce output. A social infrastructure favourable to high levels of output per worker provides an environment that supports productive activities and encourages capital accumulation. Such a social infrastructure gets the prices right so that, in the language of North and Thomas (1973), individuals capture the social returns to their actions as private returns.

Social institutions to **protect the output of individual productive units from diversion** are an essential component .... [emphasis added]

Along similar lines, Parente and Prescott<sup>12</sup> have developed the Classical economists' view that "monopoly power impedes economic progress". Acemoglu et al<sup>13</sup> have proposed that "a cluster of institutions ensuring secure property rights for a broad cross-section of society ... are essential for investment incentives and successful economic performance. In contrast, *extractive institutions*, which concentrate power in the hands of a few and create a high risk of expropriation for the many, are likely to discourage investment and economic development".

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<sup>11</sup> Hall, R.E. and Jones, C.I., "Why Do Some Countries Produce So Much More Output Per Worker Than Others?", *Quarterly Journal of Economics* 114: 83-116, 1999, p.84.

<sup>12</sup> Parente, S.L. and Prescott, E.C., "Monopoly Rights: A Barrier to Riches", *American Economic Review* 89(5): 1216-1233, p.1216

<sup>13</sup> Acemoglu, D., Johnson, S. and Robinson, J.A., "Reversal; of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution", *Quarterly Journal of Economics* 117(4): 1231-1294, November 2002, p.1235.

Easterly<sup>14</sup>, Stiglitz<sup>15</sup>, Barro<sup>16</sup>, Olson<sup>17</sup>, Engerman and Sokoloff<sup>18</sup>, and Rodrik et al<sup>19</sup> are among the many prominent economists and economic historians who in recent years have concluded that institutional arrangements, and particularly those which relate to freedom from appropriation of monopoly rents and general incentives for investment, are the single most important determinant of relative growth performance across countries.

The conclusion to be drawn from that literature is that there are significant dynamic benefits likely to flow from squeezing out monopolistic distortions from markets, and these are very likely to more than offset any costs of regulation.

### *Efficiency Implications of Transfers 2: Rent-Seeking*

A separate literature by authors including Posner<sup>20</sup>, Tullock<sup>21</sup>, Buchanan<sup>22</sup>, Krueger<sup>23</sup>, and Rogerson<sup>24</sup> focuses on the drag to economic performance that results from diversion of society's scarce resources from productive activity to unproductive rent-seeking when institutional arrangements are open to capture and private monopoly rents can be secured by such capture.

To illustrate the economic theory of rent-seeking, I reproduce below a diagram and some of the accompanying text from pages 458-459 of the textbook *Microeconomics*, by Michael L. Katz and Harvey S. Rosen (3<sup>rd</sup> ed, Irwin/McGraw-Hill, 1998). The diagram

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<sup>14</sup> Easterly, W., *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*, MIT Press, 2002.

<sup>15</sup> Stiglitz, J., *Globalization and its Discontents*, Allen Lane, 2002.

<sup>16</sup> Barro, R.J., *Determinants of Economic Growth*, MIT Press 1999.

<sup>17</sup> Olson, M., *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, Basic Books, New York, 2000.

<sup>18</sup> Engerman, S.L. and Sokoloff, K.L., "Institutions, Factor Endowments, and Differential Paths of Growth Among New World Economies", *Journal of Economic Perspectives* 14 (3): 217-232, Summer 2000.

<sup>19</sup> Rodrik, D., Subramanian, A. and Trebbi, F., "Institutions Rule: The Primacy of Institutions Over Geography and Integration in Economic Development", NBER Working Paper 9305, October 2002.

<sup>20</sup> Posner, R., "The Social Costs of Monopoly and Regulation", *Journal of Political Economy* 83: 807-827, 1975.

<sup>21</sup> Tullock, G., "The Welfare Costs of Tariffs, Monopolies, and Theft", *Western Economic Journal* 5: 224-232, June 1967, reprinted as Chapter 3 in Buchanan, J.M., R.D. Tollison, and G. Tullock (eds) *Toward a Theory of the Rent-Seeking Society*, Texas A&M Press 1980; Tullock, G., *The Economics of Special Privilege and Rent Seeking*, Kluwer Academic Publishers 1989.

<sup>22</sup> Introduction to Buchanan, J.M., R.D. Tollison, and G. Tullock (eds) *Toward a Theory of the Rent-Seeking Society*, Texas A&M Press 1980.

<sup>23</sup> Krueger, A.O., "The Political Economy of the Rent-Seeking Society", *American Economic Review* 64: 291-303, June 1974.

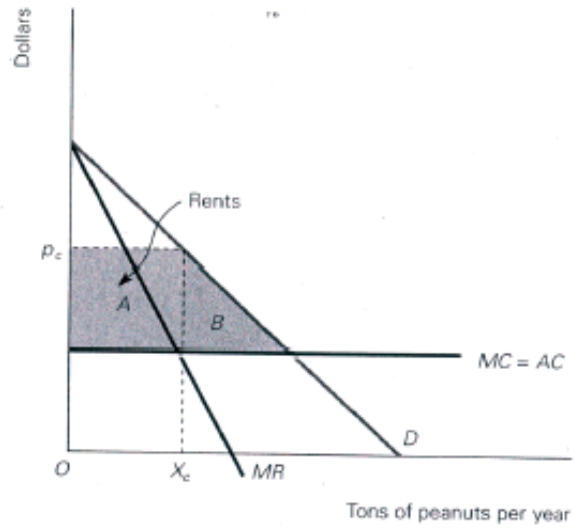
<sup>24</sup> Rogerson, W.P., "The Social Costs of Monopoly and Regulation: A Game Theoretic Analysis", *Bell Journal of Economics and Management Science* 13: 391-401, Autumn 1982.

is drawn for the case of a cartel but applies also to a monopoly, and the relevant passage in the text is headed "The Welfare Cost of Monopoly Reconsidered."

**Figure 14.6**

**Rent Seeking for a Peanut Cartel**

With a cartel, output is  $X_c$  and rents are area  $A$ . Hence, members of the cartel are willing to pay up to  $A$  in return for government enforcement of the cartel. If rent-seeking consumes resources, then the welfare cost of the cartel is  $B + A$ .



Rent seeking is the driving force behind the demand for political favors, because incumbents in an industry with existing entry restrictions typically are willing to spend money to maintain their favored position. In the same way, firms that see an opportunity to obtain rents if certain government actions are taken will devote resources to convincing politicians and regulators to take those actions. In the caustic words of O'Rourke (1991, 210), "When buying and selling are controlled by legislation, the first things to be bought and sold are legislators."

What is the maximal amount that a group of firms would be willing to pay to obtain or maintain a favored position? Because rents are a payment above that required to stay in an activity, the most that the firms would be willing to pay for their favored position is the total amount of rent. In terms of the peanut cartel example in Figure 14.6, this is shaded area *A*.

An important implication of the rent-seeking model is that the welfare cost of market power may be higher than we otherwise might have supposed. According to the standard analysis developed in Chapter 13, the welfare cost of monopoly is found (in Figure 14.6) by taking the loss in consumer surplus generated by the monopoly (area *A + B*) and subtracting from it the monopoly's rents (area *A*). Thus, the welfare cost is area *B*. This calculation assumes that economic rents represent a lump sum transfer from consumers to producers. That is, while this transfer may have important redistributive implications, it has no impact on efficiency. The theory of rent seeking, however, puts area *A* in a rather different light. Rent seeking can use up resources—lobbyists spend their time influencing legislators, consultants testify before regulatory panels, advertisers conduct public relations campaigns, and so on. Such resources, which could have been used to produce new goods and services, are instead consumed in a struggle over the distribution of existing goods and services. Hence, area *A* does not represent a mere lump sum transfer; it is a measure of real resources used up to maintain a position of market power. In short, according to this view, the deadweight loss of monopoly is *B plus A*.

Both of these two strong currents of thinking in the economics profession show that it is wrong to claim without qualification that transfers are "neutral in efficiency terms". I therefore note with some surprise that in his evidence on behalf of Telecom, Professor Katz appears to have neglected to include rent-seeking as one of the relevant factors the Commission should consider when applying a total surplus standard, as Telecom urges it to do.

### **3. Which Test Applies under ss.18 and 19 of the Telecommunications Act 2001?**

Various New Zealand statutes provide for the Commission to apply a variety of tests in different circumstances. For the authorization of restrictive practices, and of mergers and takeovers, the Commission is directed to take a public-benefits approach.

The 2004 High Court judgment in *Air New Zealand and Qantas Airways Ltd v Commerce Commission & Ors*, 17 September 2004, unreported, has ruled (at [239] – [242]) that in authorisation cases, the practice of ignoring transfers when conducting a public benefits test should continue, since the addition of the new purpose section 1A to the Commerce Act in 2001 has not changed the basic purpose of the public benefit test. The Court stated that "the words 'benefit to the public' remain intact; the term 'public' is

intentionally broader than ‘consumers’; and an efficiency gain that benefits producers is still a benefit to the public.”

In undertaking Part IV inquiries into whether control should be imposed on a firm or sector, however, the Commission’s primary mandate under s.52 of the Commerce Act is to identify and measure the effects on “persons acquiring the goods or services (whether directly or indirectly)”, which means that a consumer welfare test is to be applied, with rent transfers included as a welfare loss to acquirers under the counterfactual of no regulation.

In reporting further to the Minister (if requested under s.53) on whether control should be imposed, the Commission has in effect an open brief, spelt out in s.56: “The Commission may have regard, in considering a report, to all matters it considers necessary or desirable.” This clearly leaves it open for the Commission to judge whether to retain the consumer welfare standard of s.52, or some other standard. (In the recent gas pipelines inquiry, the Commission was directly asked by the Minister to conduct a net-public-benefit (NPB) test (*Gas Control Inquiry Final Report* 29 November 2004 paragraph 4.48) and did so by subtracting transfers from its Net Acquirers Benefits figures; see Table 20.5.)

The Telecommunications Act 2001 s.18(2) sets out the criterion “long-term benefit of end-users of telecommunications services” to be used by the Commission in deciding whether regulation is justified. The Commission has interpreted this, correctly in my view, as requiring a consumer welfare test to be applied. I note that the recent High Court decision in *Air New Zealand and Qantas Airways Ltd v Commerce Commission & Ors* stated at [240] that “the term ‘public’ is intentionally broader than ‘consumers’”, which I interpret as confirming that a consumer (or end-user) focused analysis will have a narrower target (the consumer welfare test) than an analysis focusing on “the public”, a term which the Court has indicated includes producers as well as consumers.

Because the Telecommunications Act 2001 mandates a consumer welfare test, not a public benefit test, the Commission is correct to include the rent transfers in its calculations as a detrimental effect of monopoly pricing, and their elimination as a benefit of control.

#### **4. A Review of Telecom’s Submission on the Draft report**

Telecom devotes a considerable proportion of its submission to the issue of how wealth transfers should be dealt with in a cost-benefit analysis. Much of the material set out there is repetitive and irrelevant to a Telecommunications Act Part 2 proceeding. In this section I shall nevertheless work through Telecom’s arguments section by section.

Telecom's position is summarized as follows in [43.5]:

A wealth transfer from producers to consumers is neutral in efficiency terms, and should not be counted in any cost benefit analysis. For this reason a net public benefits test, and not a consumer welfare test, is appropriate.

This short passage contains two errors of economic theory, and at least one error of logic. The theoretical errors are

- (i) the unqualified assertion that wealth transfers are neutral in efficiency terms as a general matter of principle. This overlooks, *inter alia*, the point made by Professor Katz in his textbook (quoted earlier) that rent-seeking behaviour causes efficiency detriments possibly up to the full amount of the transfer;
- (ii) the claim that transfers should not be included in any cost-benefit analysis. As I have already noted, transfers will appropriately be included from the outset in a consumer-welfare based cost-benefit analysis, and should not be excluded from a public-benefit-focused study until the analyst has established that neither allocative nor dynamic efficiency detriments are associated with the transfers.

The error in logic is to argue from the alleged neutrality of transfers to adoption of a public-benefit framework. In fact the logical sequence is the other way round: choice of analytical framework logically precedes the question of whether to treat transfers as neutral.

*Telecom paragraphs 52 – 55*

Here Telecom alleges that it is “simply wrong” of the Commission to read s.18 of the Telecommunications Act as mandating a consumer-focused approach, because “there have been innumerable Commission and Court decisions establishing the neutrality of producer surplus to a net benefits test in the Commerce Act merger context.” Telecom argues that the Telecommunications Act context is “the same” as the Commerce Act merger context, whence the test should be the same.

This appears to involve a wilful failure on the part of Telecom to appreciate the distinction between the merger authorization section of the Commerce Act, where a public benefit test is required, and the regulatory context of s.52 of the Commerce Act and the related s.18 of the Telecommunications Act, both of which are consumer-focused. The legislative frameworks are clearly not the same, and it is Telecom, not the Commission, that is “simply wrong”. The legislation distinguishes clearly between different contexts, and the Commission has correctly adopted the tests prescribed by the two Acts for each particular case.

Whether or not there are “innumerable” decisions located within the merger-authorisation context is entirely irrelevant. There are certainly not “innumerable” decisions using a net-public-benefit test in a Part IV Commerce Act or Telecommunications Act context.

*Telecom paragraphs 56-57*

The Commission is accused of “erring in law and economics by treating transfers from producers to consumers as a welfare gain”. Certainly there is no error in economics here.

As for the law, again Telecom appears oblivious to the distinction between the public benefit test mandated for mergers and trade practices, and the net acquirers’ benefit test mandated for Part IV control hearings and Telecommunications Act control cases. Telecom is correct to note that the two Acts have similar purpose statements – but then suggests some inconsistency in taking a net acquirers’ benefit approach to situations where that is the approach mandated in both Acts. Lengthy quotation from the Commission’s guidelines on the public benefit test is of no avail, since they apply to the mergers and trade practices context – not price control inquiries.

*Telecom paragraphs 58 and 59*

Telecom here attempts to shelter behind the recent High Court decision in *Air New Zealand and Qantas Airways Ltd v Commerce Commission & Ors*, but in the process badly misconstrues the Court’s purpose and decision. The Court was asked to rule on whether the new s1A enacted in 2001 made any difference to the design of a public benefit test under s.67(3)(b). The Court’s answer was no. The relevance of this answer is confined to the merger authorization section of the Commerce Act; the Court made no finding with regard to Part IV inquiries, and consequently its decision does not flow over at all to interpretation of the Telecommunication Act s.18.

At [59] Telecom submits that the Court established that the words “long-term interests of consumers” are to be read as referring solely to “real resource impacts on the economy”, and that “distributional concerns are not relevant to the promotion of the purpose of the Telecommunications Act”. This goes far beyond the actual position adopted by the Court in its paragraph [241], which was explicitly concerned with the Commerce Act merger context and did not consider the situation with inquiries under s.52. It is inconceivable that the Court could have intended, even obliquely, to suggest that rent transfers are irrelevant to the calculation of consumer gains from control of prices under the net acquirers’ benefit test. In trying to insist that “the legal position is that transfers are to be treated as welfare neutral” whenever the long-term interests of consumers are being considered, Telecom stretches the Court’s findings far beyond anything that is to be found in the words of the decision.

*Telecom's paragraphs 60-62*

Here Telecom attacks the Commission's view that there is a different philosophical base for control than that which applies to competition as a regulatory mechanism. The attack rests on two propositions: that the High Court judgment in *Air New Zealand and Qantas Airways Ltd v Commerce Commission & Ors* has ruled out regulation to control monopoly profits (it clearly did no such thing); and that there exists a so-called "settled treatment of wealth transfers" in interpreting the purpose statements in the Commerce Act and Telecommunications Act, such that wealth transfers are always to be treated as welfare neutral. There does not, of course, exist any such "settled" position. The purpose statement of the Commerce Act must be presumed to cover s.52 (where monopoly rent transfers are clearly and directly relevant to the decision on whether to recommend price control) just as it covers s.67(3)(b) where a public benefit test is required. Insofar as the Commission is distinguishing between those two contexts – one which requires it to take account of transfers, and one which does not – its distinction makes perfect sense. Telecom's assertion that "the distinction ... does not exist" is simply baseless.

In paragraph 63 Telecom continues to repeat references to the merger authorization issue as though it had some bearing on the present case. It has no such bearing, and its relevance is in no way enhanced by constant repetition.

Paragraph 64 continues in this theme - "the fact that wealth transfers were irrelevant to the authorization analysis". As already noted, this is not an authorization hearing, and the point is consequently irrelevant.

Paragraph 65 accuses the Commission of straying "far outside the legal framework and economic orthodoxy". I detect no departure from acceptable mainstream economic thinking about regulation of monopoly, and as already noted the Commission seems to me to be operating clearly within its legal mandate under the relevant Act.

Telecom alleges, in support of its "straying" proposition, that the Commission would recommend "a regulatory intervention that reduced New Zealand's net welfare, as long as the transfer from producers (and their shareholders) to consumers was sufficiently large". Telecom unfortunately offers no hypothetical example of the sort of case it might have in mind here, and without such an example it is difficult to predict what the Commission would decide.

Telecom alleges also that the Commission would count as a benefit a transfer from Telecom and Vodafone to other corporates and businesses (insofar as they are end-users). This seems an unobjectionable conclusion insofar as those other business are end-users of telecommunications services. It is entirely unclear to me why Telecom should regard it as improper to treat as a welfare benefit a price-control policy that reduced the downstream cost of telecommunications inputs to other sectors of the economy.

Over the next three pages Telecom engages in a series of confused arguments in an attempt to buttress its “transfers are always and everywhere neutral” stance.

Paragraph 69 claims that “counting the transfer of perceived monopoly profits from producers to consumers as a benefit does not make sense....because transfers are welfare-neutral”, and because “the legal framework treats distributional concerns as irrelevant”. Both statements are the opposite of the truth. Ignoring transfers in the context of a control inquiry is what would make no sense; and the legal framework does not treat distribution as irrelevant in control inquiries. Repeated and willful refusal by Telecom to take account of the distinction between authorization and control cases results in a series of incoherent and rambling charges against the Commission that have no substance.

Paragraph 78 claims the High Court has given “explicit directions... to treat distribution concerns as irrelevant to any net benefit analysis”. The Court judgment contains no such directions in the case of control inquiries. As a matter of simple economic principle, it would be profoundly unwise and misleading to exclude distribution from any net benefit analysis. A Net Acquirers’ Benefit analysis, for example, inescapably must include distributional estimates.

Paragraphs 71-74 attempt to construct an argument from legislative history demonstrating that Parliament intended wealth transfers to be ignored in any and every proceeding under the respective Acts. As I noted in my previous submission, with regard to local loop unbundling, “the long-term benefit of end-users’ would be an odd expression for Parliament to use if in fact it meant the long term benefit of society at large”.<sup>25</sup> The statement by Hon. David Cunliffe, quoted by Telecom in its paragraph [72], appears to me to support the view that Parliament’s intention was to focus narrowly on end-user welfare rather than broadly on public benefit. I draw the same conclusion from Parliament’s reject of the “Baumol-Willig Rule” in the schedule to the Telecommunications Act 2001, and on its specification of a cost-based pricing methodology for interconnection charges.

Paragraphs 75-77 rely upon a Treasury paper from the LLU context which seems to fail to grasp the essential difference between the test to be applied by the Commission in the merger and acquisition context, and that required for price control investigations.

*Paragraphs 78-84: Affirmation of the settled approach by Government*

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<sup>25</sup> Geoff Bertram, *Unbundling the Local loop in New Zealand: Some Economic Issues Raised by Telecom’s Evidence*, Wellington: Simon Terry Associates, November 2003, p.22.

Here Telecom resorts to a series of largely anecdotal cameos which supposedly should lead the reader to the view that Government has in some way ruled out any consideration of transfers under any circumstances.

First Telecom notes that in the gas pipelines inquiry the Commission was asked by the Minister to report to him on a net (public) welfare basis. Casual inspection of section 53 of the Commerce Act shows the Minister was perfectly entitled to do this, and the Commission was perfectly correct to report accordingly (in Chapter 20 of their final report) without altering in any way the consumer-welfare focus of s.52. The relevance of this anecdote to Telecom's general claim is zero.

Next Telecom points out that the "interests of acquirers threshold" has never carried the day in the government's decision-making. Whether correct or not as an observation, this cannot be taken as indicating any Government view that the Commission should change its s.52 investigation methodology.

At [80] Telecom proposes that since the Commission is reporting to the Government (including Treasury) and since Government generally makes decisions on a net-public-benefit basis, the Commission "has no mandate to do otherwise" than report in the same terms. This entirely misreads the simple wording of s.52 of the Commerce Act, and corresponding provisions in the Telecommunications Act. Parliament has explicitly mandated the Commission to report on a consumer-welfare basis in control cases; what Government may choose to do with the recommendations is the Government's business and has no relevant whatever in determining the Commission's statutory mandate and function.

#### *Paragraphs 81-83 AMPS-A case*

Here Telecom puts forward a highly tendentious interpretation of AMPS-A, denying that it has any reference to distributional issues such as wealth transfers. However, the "functionless rents" discussed by the Court in that case were clearly synonymous with wealth transfers from consumers.

Finally in paragraph 84 Telecom comes to a halt, insisting that its view is shared by the High Court and the Government, and referring to its lengthy and equally confused submissions on wealth transfers in the LLU case. As I have been through those submissions in detail in my own evidence in the LLU case<sup>26</sup> I shall refrain from revisiting that ground here.

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<sup>26</sup> Geoff Bertram, *Unbundling the Local loop in New Zealand: Some Economic Issues Raised by Telecom's Evidence*, Wellington: Simon Terry Associates, November 2003, pp.23-30.

## 5. A Review of the Submission of Professor Katz

In a sense it is ironic to encounter Professor Katz giving evidence in support of Telecom's position in these hearings. Professor Katz has a distinguished record as a regulator in the Federal Communications Commission in the USA, where the consumer welfare standard is the criterion used to evaluate regulatory interventions. As Professor Katz notes at [5], his staff of economists' "principal professional focus was on understanding and projecting the impacts of various business practices and public policy decisions on consumers' economic welfare"; and at [56] he points out that in the USA, "Federal competition policy statutes largely promulgate a consumer welfare standard, which is very similar to the concept of long-term end-user benefits".

Coming from this background, Professor Katz at no stage personally endorses Telecom's promotion of the total-surplus standard and the consequent proposed exclusion from analysis of the transfers from producers to consumers consequent upon regulation. Repeatedly Professor Katz resorts to statements about the New Zealand regulatory regime which are of the form "if [this is the way you do things here]..... then ...[it follows that...]". I could find no passage in his evidence which commits him personally or professionally to support for the total-surplus standard on its own as an appropriate criterion for regulation. Nor could I find anywhere even a comment to the effect that some jurisdiction known to Professor Katz, other than New Zealand, uses the total surplus standard in the unqualified form advocated by Telecom.

In the present case this is significant because of the way it undercuts the repeated claims in Telecom's submissions that the total-surplus standard enjoys wide professional support among economists and other practitioners.

At [6] Professor Katz indicates that his evidence will lead to two conclusions: "that the *Draft Report* misconstrues the concept of long-term benefit of end-users and uses an inappropriate methodology to project the likely effects on end-user benefits of regulating mobile termination rates."

The reasoning underlying these two conclusions is supposedly summarised in paragraph [7], which consists of twelve bullet points. These have been crafted to avoid conflict with Telecom's submission, but do not always match the substantive arguments in the main body of Professor Katz' report, and in particular cannot be taken to commit Professor Katz to advocacy of the total-surplus standard rather than the consumer welfare standard.

Take the first bullet. This reads:

*End-users have a broad, long-term economic interest in regulatory policies that promote efficiency. The pursuit of regulatory policies that promote efficiency will maximize the total benefits that are available to end-users in their roles as consumers, workers and owners. A common*

view among economists is that, although market outcomes are not necessarily fair, it is sensible to have a division of labor among policies under which economy-wide tax schemes are used to redistribute income and market-specific governmental intervention is limited to correcting market failures or their effects. [Emphasis added].

The first two sentences here set out the uncontentious proposition that the economy as a whole benefits from policies which promote efficiency; this is surely not at issue, except insofar as Telecom has put forward a case against the Commerce Commission recommending such market interventions. The total surplus standard and consumer welfare standard point to the same ultimate ideal target for regulatory intervention, namely to equate social (long-run) marginal benefit and social (long run) marginal cost at the margin of the relevant market. (The thrust of Telecom's argument is that the Commission should refrain from moving the market to that optimal position on the grounds that the regulatory cost of doing so is unacceptably high.)

The second sentence of Professor Katz's first bullet in [7] contains a distinction between "end-users" and "consumers". The definition of end-users advanced here comprises the adult population as a whole "in their roles as consumers, workers and owners." This definition is obviously at odds with the Commission's interpretation in the Draft Report which clearly (at [66]) equates end-users with consumers<sup>27</sup>. It also fits uneasily with the definition of "end-user" in s.5 of the Telecommunication Act 2001:

**"end-user"**, in relation to a telecommunications service, means a person who is the ultimate recipient of that service or of another service whose provision is dependent on that service

Extending the definition to encompass economy-wide ownership issues and employment status ("workers and owners") is not obviously sensible or legitimate. In addition, extending the definition to encompass a wide range of social groups outside the market being analysed raises serious aggregation problems.

Upon a careful reading of the remainder of Professor Katz's report, it turns out that he does not in fact adopt the concept of end-users contained in the first bullet of [7]. In the main body of the report the term "end-user(s)" appears 81 times and the word "consumer(s)" 63 times, with the two used interchangeably to refer to the same group. Perhaps most telling is that in [65] a clear separation of interests is made when Professor Katz refers to "distribution of incomes among end-users and the owners and workers of producers" [emphasis added].

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<sup>27</sup> In passing I should record my personal view that the Commission has correctly interpreted the purpose of the Telecommunications Act 2001 as referring to consumers of telecommunications services rather than the population at large.

The definition of “end-user” embodied in [7] is also not consistent with the definition developed by Professor Katz in section IIIA of his report, which starts by noting that “‘long-term benefit of end-users’ is not an economics term of art” ([12]) and then lays out in paragraphs [13] to [17] an analysis which equates end-users with consumers of telecommunications services, both corporate consumers and households. Paragraphs [16] and [17] are especially clear in limiting the definition of end-users to those who, by connecting to a telecommunications network, simultaneously create and benefit from network effects.

Turning to the third sentence of the first bullet in Professor Katz’s paragraph [7], I note that the policy prescription he describes there is described only as a “common view among economists”, and that he provides no indication of the extent of professional disagreement that may exist among economists over the proposition that “although market outcomes are not necessarily fair, it is sensible to have a division of labor among policies under which economy-wide tax schemes are used to redistribute income and market-specific governmental intervention is limited to correcting market failures or their effects.”

I agree with Professor Katz that the quoted view is commonly encountered among economists, but I think it is important to bear in mind that most of those economists would be equating “market outcomes” with “competitive market outcomes” – not with the outcomes in markets where market power has been exercised at consumers’ expense to drive price up and quantity down.

The general view among mainstream economists would be, I believe, that appropriate regulatory or other intervention should be undertaken to bring the market as close as possible to the outcomes that would prevail under competitive conditions, by eliminating or restricting the distortions caused by exercise of monopoly power, before addressing the issue of whether the resulting distribution of income may be so “unfair” (whatever that means) as to warrant separate intervention via the tax system. This certainly is the position of Harberger (1971), reviewed above. Generally it is considered preferable to tackle identifiable market distortions directly via targeted intervention to remove the distortion at source, rather than indirectly by, for example, shuffling taxes and transfers.

Taking the converse of this, most economists would, I believe, agree that introducing distortions into a previously-competitive market is an inefficient means of pursuing economy-wide distributional objectives, which are better addressed by taxes and transfers. This belief does not entail the position advanced by Telecom, that using taxes and transfers to correct for the distributional consequences of monopolistic distortions is an efficient policy response to such distortions. The general prescription would be to address the market distortion directly at source, thereby eliminating their distributional consequences while simultaneously improving economic efficiency.

The elimination of monopoly-rent transfers from consumers to suppliers is a collateral benefit of intervention to eliminate or reduce monopolistic distortions of prices and quantities in a market. This distributional consequence of regulation is appropriately included among the benefits of regulation, since (i) the elimination of market distortions relieves the Government of the need which otherwise might arise to implement tax and transfer policies to offset undesired distributional outcomes from the existence of unregulated monopoly<sup>28</sup>; and (ii) the benefits of regulation are appropriately measured in terms of gains for end-users (consumers).

I have dwelt at length upon the first bullet in Professor Katz' paragraph 7 because this is the one of most substantive importance in the remainder of his evidence. Turning to the others, I shall be briefer.

The wide definition of "end-user" briefly adopted by Professor Katz in his paragraph [7] would clearly run into aggregation issues because the interests of the three groups he includes (consumers, workers and owners) conspicuously do not always coincide, and in many cases will be directly at odds with each other. Hence to actually determine the interests of his end-users in relation to, e.g., regulation of mobile termination rates, Professor Katz would be placed in the difficult position of having to decide what welfare weights to assign to each of his three groups in calculating the aggregate interest of end-users.

Professor Katz clearly acknowledges this problem in his eighth bullet point in paragraph [7]. There he hints on possibly using identical unit weights across all three groups, on the basis that the rule-of-thumb "a dollar is a dollar" is "often" used to aggregate benefits. The remainder of his evidence nowhere embarks upon the actual empirical evaluation of costs and benefits, but his implicit acknowledgment that in aggregating gains and losses to reach a net welfare gain or loss, some weighting scheme is required, and that simple monetary aggregation is not the only way of solving this, cuts directly across Telecom's assertion that transfers between consumers and firms should in principle be measured as netting-out to zero.

This leads me to surmise that Professor Katz' adoption in [7] of a very wide definition of "end-user" is motivated more by a desire to avoid having to discuss at more length the consumer welfare standard, which is the long-established and generally-accepted standard for regulation of prices in the USA, and under which he has undertaken the bulk of his professional work as an economist.

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<sup>28</sup> One implication of this, which I shall not pursue here, is that in estimating the costs and benefits of regulatory intervention, the Commission could appropriately include an estimate of the avoided cost of implementing tax-transfer policies to correct for the undesired distributional consequences of market distortion. This would mean subtracting from the "costs of regulation" a sum representing an estimate of the "avoided cost of tax-transfer measures to compensate for undesired distributional consequences of unregulated monopoly".

Bullet 2 argues that when an action affects multiple prices, the effect on end-users will depend on the full set of price changes. Bullet 3 claims that the Draft Report fails in this respect because it takes no account of the “waterbed effect” on mobile handset and subscription prices. Since the Draft Report does in fact address the waterbed effect (concluding that it is not likely to occur) bullet 3 is really just a disagreement of Professor Katz with the Commission’s judgment – not a difference in principle.

Bullet 4 notes that supplier investments “can” be adversely affected by price reductions. Professor Katz does not claim here or elsewhere that the contemplated reductions in mobile termination prices will have such an effect, and in bullet 5 he addresses an entirely different dynamic efficiency issue, namely whether exemption of 3G from the proposed regulatory cap may reduce investment due to time inconsistency. Here Professor Katz offers an unambiguous opinion that such a dynamic detriment will occur; again his disagreement with the Commission is one of empirical judgment, not of principle. Since he puts forward neither reasoning nor evidence to support his position, it is difficult to comment further.

Bullet 6 notes that if the market is “two-sided”, then benefits depend on the prices at both sides, and cost-based rules at one side alone will fail to maximize either efficiency or end-user benefits. This is of course a statement of general principle which is contingent on the truth of the “if” clause. Bullet 7 claims that the Commission has fallen into this error by failing to consider effects on the other side of the market. Professor Katz does not offer any evidence for the two-sidedness of the market; nor does he acknowledge that the Commission reached its conclusion that the market is not two-sided by an explicit discussion of whether the “waterbed effect” would occur. Hence caution prevails in Professor Katz’s conclusion, that “the net result predicted by a full analysis could be that all end-users would be worse off as a result of the proposed regulation.” This is of course a completely empty statement, since it leaves open the countervailing possibility that the full analysis could turn out to support the Commission’s conclusions.

Bullet 8 points out the need for some aggregation procedure when some end-users lose while others gain, and paragraph 9 develops this into a convoluted and confused line of argument in favour of excluding transfers from the calculation of regulatory costs and benefits. I deal in detail with this line of argument in a later section of this paper.

Bullet 10 notes correctly that competition is generally considered to promote efficiency, but bullet 11 argues that elimination of monopoly rents is not an efficiency benefit – at least not “under the two leading economic conceptions of efficiency”. Again I deal with this in detail below.

This leaves bullet 12, which says that the preceding eleven bullets amount to a basis for treating the Commission’s calculations as unreliable.

*Definitions: The Correct Construction of “the long-term benefit of end-users”*

Part III.A of Professor Katz’ report tackles the issue of what is meant by the expression “long-term benefit of end-users”. Supposedly his reasoning in this part (pages 5-9, paragraphs [9] – [25]) provides the underpinning of his expressed conclusions in [6] that “the *Draft Report* misconstrues the concept of long-term benefit of end-users”. As I have already pointed out, Professor Katz’ paragraphs [12] – [17] in fact coincide with the Commission’s interpretation of the term end-user, and in the process undercut both Telecom’s contention that end-users are identical with the population at large, and the very broad conception of end-users that has been slipped into the first bullet of [9].

Let us consider closely Professor Katz’s statements on definitional matters. Paragraphs [18] - [25] address the meaning of the term “long-term benefit”. I can find nothing in these paragraphs that conflicts with the positions adopted by the Commission in its *Draft Report*. Paragraphs [18] – [23] focus on the individual consumer (using throughout the term “consumer” rather than “end-user”) and list a series of familiar propositions which are to be found in the Commission’s *Draft Report* – for example,

- that (paragraphs [19] and [20]) the analyst must consider all the prices affected, not just one (the Commission did consider, but rejected, the waterbed proposition which is evidently what Professor Katz had in mind);
- that (paragraphs [21] and [22]) dynamic effects on investment and hence future supplies must be considered (the Commission did so)
- that (paragraph [23] costs and benefits will be spread over time and hence issues of weighting and discounting must be confronted in calculating a net present value (the Commission would certainly not disagree).

Paragraphs [24] and [25] raise the issue that some end-users might gain while others lose from the intervention, and note that economists have developed tools for aggregation and discounting. The Commission’s *Draft Report* revealed no need to be concerned about these matters, since there did not appear to be any group of end-users who would be harmed by the proposed regulation. Professor Katz in his report certainly makes no attempt even tentatively to identify such a group of consumers, which means that his paragraphs [24] and [25] completely lack relevance in this case.

To this point no substantial argument has emerged from which Professor Katz could validly conclude that (paragraph [6]) “the *Draft Report* misconstrues the concept of long-term benefit of end-users”. I turn therefore to Part III.B of Professor Katz’s report, dealing with “efficiency”. Paragraphs [28] – [30] deal with Pareto efficiency, and paragraphs [31] – [34] with total-surplus efficiency.

Take first Pareto efficiency. Professor Katz’s account is entirely standard and uncontentious, pointing out that Pareto efficiency requires that no individual can be made better off without making another individual worse off. An important point which should

follow naturally from this, but which Professor Katz unaccountably fails to point out, is that in a market that is allocatively inefficient because of monopoly pricing there is, in principle, a Pareto gain available from forcing the price down to the competitive level, since the gains from reducing deadweight losses accrue as a form of free lunch<sup>29</sup>. Pareto efficiency, as a general guide for policymakers, strongly supports the position of the Commerce Commission and contradicts that of Telecom in the present case.

Take next total-surplus efficiency. This is the maximisation of the sum of consumer and producer surplus, without regard to their distribution. Again Professor Katz's account is entirely orthodox, and presents no threat whatsoever to the Commission's *Draft Report*. He notes that a first-best outcome of total surplus maximization occurs when marginal social costs and benefits are equated, and then outlines a second-best situation where some constraint prevents the policymaker from attaining the first-best – for example, economies of scale which make it necessary to allow the supplier a margin over marginal cost to remain financially viable; or imperfect information which prevents the policymaker from identifying precisely the optimal price-quantity combination. All of this is clearly understood by the Commission, and underlies its *Draft Report*.

Part III.B of Professor Katz's report consequently presents no challenge to the Commission's approach and identifies no way in which the Commission has "misconstrued" anything.

This brings us to Part III.C which addresses "the relationship between long-term benefits and efficiency". Here Professor Katz labours to find some error in the Commission's approach, but fails. He correctly notes that maximizing consumer benefits is not "logically [i.e. necessarily] equivalent to maximizing total surplus" (paragraph [35]) but notes that "in the long run, end-users' interests are generally best served by the pursuit of efficiency" (paragraph [37]). "An end-user's interests are best served by an approach to public policy that pursues efficient outcomes" (paragraph [38]); while "end-users will tend to be harmed in the long run if suppliers' investment and production incentives are distorted" (paragraph [38] again.) These points all coincide with the Commission's approach in the *Draft Report*.

Two paragraphs, [36] and [37], address the question of transfers. Professor Katz is careful to limit his discussion to the two particular efficiency concepts he has discussed, namely Pareto and total-surplus efficiency. This enables him to say (carefully choosing his words) in paragraph [36], that "using either Pareto optimality or total-surplus maximization as the concept of efficiency, wealth transfers do not generate efficiency benefits". The Commission has already made precisely this point, and Professor Katz identifies the appropriate reference in the *Draft Report*.

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<sup>29</sup> Of course, the incumbent monopolist whose price is forced down may well end up worse off in fact while consumers are better off – but the Hicks-Kaldor compensation principle affirms that the change can be treated as a Pareto gain even if actual compensation is not paid to the monopolist. For the criterion, see paragraphs [63] and [64] of Professor Katz' report.

Having narrowed down his concept of “efficiency” to Pareto or total-surplus efficiency, Professor Katz then goes on in [37] (mis-numbered 39) to say that “the fact that wealth transfers are not efficiencies would seem to indicate a potential tension between efficiency and end-user benefits.” Here Professor Katz is guilty of some looseness in his logic, since he has established only that the two main efficiency measures do not include transfers – he has not established a general “fact”. In addition, he is guilty of introducing a line of irrelevant discussion which unhelpfully obscures the main thrust of his argument. He points out that it is possible to conceive of a policy that “gives rise to deadweight losses” so that although consumers gain, the loss to producers is greater and total surplus is diminished. He immediately concedes (paragraph [37] on p.14) that “although one can construct such examples ... this is a misleading perspective.” I would strongly agree with this concession, which leaves me wondering why Professor Katz thought it worth even mentioning the hypothetical possibility.

We still lack any coherent account in Professor Katz’ evidence that might substantiate the proposition that the Commission’s *Draft Report* has misconstrued anything. We are left with only two paragraphs – numbered [39] and [40], pp.14-15.<sup>30</sup>

These two paragraphs are the only point where Professor Katz comes even close to putting forward the proposition that a measure of the “long-term benefit of end-users” should exclude transfers. His reasoning is therefore of the utmost interest, because of the critical importance attached by Telecom to this proposition. Somewhat surprisingly, he does not in fact offer any logical reason for excluding transfers from the calculus of benefits. He resorts instead to selective quotations from two official papers, one of which (the Ministry of Economic Development briefing cited in paragraph [40]) is clearly confused.<sup>31</sup>

Only by taking as authoritative the Treasury’s suggestion that “the long-term benefit of end-users” is equated in New Zealand completely with the total-surplus standard, whence transfers are to be ignored, is Professor Katz in a position to say that “from the perspective of economics, in each case, the stated policy objective corresponds to one of maximizing total surplus and does not appear to leave any scope for counting wealth transfer from New Zealand producers to New Zealand consumers as net benefits” [emphasis added].

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<sup>30</sup> The numbering in the version of Professor Katz’ evidence on the website is not consistent between [30] and [40]. I have endeavoured to account for this in my references.

<sup>31</sup> In my November 2003 report for TelstraClear in the local-loop-unbundling case, available on the Commission’s website at <http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/Investigations/LocalLoopUnbundling/ContentFiles/Documents/TCLReportBertram.PDF> , I commented (p.28) in relation to the same MED officials’ briefing paper that “no amount of selective quotation from officials’ briefing papers can turn black into white.” I reiterate that view here.

It has to be emphasized that Professor Katz is not here offering his professional expert opinion that transfers are not to be counted as net benefits. He is offering merely a translation into economics of a “stated policy objective” laid down in two sets of officials’ briefing notes. Insofar as the premise is incorrect, the conclusion falls. Had Professor Katz been asked to translate an official statement that consumer welfare was to be the primary concern, he could have said, equally correctly, that transfers were net benefits.

Not only does this mean that paragraph [40] of Professor Katz’ report is merely reportage of the views of others; it also runs directly counter to the version of end-user benefits set out by Professor Katz in Part III.A of his evidence. It runs counter also to the usual practice in the regulatory jurisdiction from which Professor Katz own expertise is derived, namely the USA, where the consumer welfare standard is taken for granted. It is therefore to be regretted that in preparing his evidence, Professor Katz did not enquire more thoroughly into the question of what in fact the policy objective of the Telecommunication Act 2001 is. As matters stand, he appears not to have conducted sufficient research of his own to establish the legislative policy objective, and hence his interpretation of the policy with respect to the treatment of transfers is not well founded.

At this point, halfway through Professor Katz’ evidence, we find that his strong assertion that the Commission has “misconstrued the concept of long-term benefit to end-users” turns out to represent no more than the trivial observation that the Commission has adopted a different interpretation of the purpose of the Telecommunication Act 2001 from that put forward by Treasury officials<sup>32</sup> at a select committee hearing. We are here very far from any authoritative rebuttal of the Commission’s position. Professor Katz in fact does not regard it as the economist’s job to prescribe policymakers’ goals – merely to “determine the effects of various policies on the attainment of policymakers’ goals” (footnote 18 p.17 of his evidence). Hence his apparently strong conclusion in paragraph [6] collapses to merely drawing a logical conclusion from a (highly contested) view of the policy objective put forward by someone else.

The middle section of the Katz report addresses the role of competition and consists mainly of orthodox material until paragraph [50], where he abruptly launches an attack on the Commission’s distinction between regulation and competition in relation to transfers. Again Professor Katz does not offer any authoritative view of his own; merely a disjointed pair of “if ... then” statements:

If the specific policy objective is to eliminate monopoly profits through regulation, then *by definition* it is true that control as a regulatory mechanism should seek to eliminate monopoly profits. But if, as most economists would

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<sup>32</sup> The quotation from the Treasury briefing in paragraph [39] of the Katz report does not in fact clearly lay down the total surplus standard. There are other passage in that Treasury briefing that do adopt such a position, but Professor Katz appears to have been directed to the wrong passage when preparing his evidence.

reason, the virtue of competition is that it promotes efficiency and that - where regulation is used – it should seek to replicate the benefits of competition in promoting efficiency, then this statement [the Commission’s paragraph 60] badly misses the mark.

This paragraph is merely words without substantive content. It engages in a play on words to make it appear that the Commission is in some way at odds with “most economists”. The word “but” in the middle of the paragraph gives the false impression that two opposing positions are being juxtaposed, which is not in fact the case.

The resort to semantic devices rather than serious argumentation continues in paragraphs [51] through [53].

Paragraph [51] opens with the claim “The efficiency role of competition is very different from the *Draft Report’s* contention that the primary benefit of competition is that it eliminates monopoly profits”. Clearly both economic efficiency and desirable wealth transfers can emerge as joint products of either regulation or the promotion of competition. Which of these two benefits should be treated as “primary” is a matter of taste and of the policy objective being pursued. Far from indicting the Commission for some fundamental error, it turns out in paragraph [52] that Professor Katz is saying no more than that “the *Draft Report* risks [underlining added] confusing two distinct roles that prices play in a market economy. One is to provide incentives to producers and consumers that help guide their investment, production, and consumption decisions. The other is to transfer wealth among various parties to an economic transaction. Efficiency effects arise from the former, not the latter”.

No evidence is presented that the Commission has actually confused anything – only that it has run some poorly-described “risk” of doing so.

Paragraph [55] continues the practice of piling unrelated and often irrelevant statements on one another as though some point is thereby made against the Commission. Policy makers are perfectly entitled, Professor Katz says, to pursue objectives other than competition and efficiency. Hence, one might have expected him to conclude, if the Commission chooses to give primacy to consumer welfare, and if the means it uses to pursue that objective coincide neatly with the requirements of economic efficiency, then surely there is no problem.

There follows a section, IV.C, which is of more interest and importance. Here Professor Katz does address directly the relationship between a consumer welfare standard and the promotion of competition.

In paragraph [55] Professor Katz quotes from the Commerce Act 1986 to establish that the Act focuses on protection and promotion of the competitive process, with a strong focus on the efficiency properties of competition. He notes, correctly, that monopoly

profits *per se* are not illegal in New Zealand. He then draws the entirely unwarranted conclusion that “New Zealand’s competition policy is not focused on transferring rents to consumers. Rather, the concern is with preventing anticompetitive actions that would harm efficiency and, thus, harm consumers”.

The trap into which Professor Katz here stumbles is that he has read only selected portions of the Commerce Act which focus on competition, and has evidently failed to notice that other parts have a different focus – specifically, a focus on transferring monopoly rents to consumers. As the Privy Council pointed out in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 :

“It is important to note that s.36 is only one of the remedies provided by the Commerce Act for the purpose of combating over-pricing due to monopolistic behaviour...

... Part IV deals separately with control of prices.... Therefore s.36 is only part of an overall statutory machinery for dealing with trade practices which operate to the detriment of consumers. Another part of such machinery (Part IV) is specifically directed to the regulation of prices in markets which are not fully competitive....

s. 36 is designed to produce the competition which will, it is hoped, in due course compete out monopoly rents; Part IV of the Act enables immediate price restriction to be imposed by regulation. Since the Commerce Act contains the machinery for dealing with the monopoly rents in both ways, it would, in their Lordships’ view, be wrong to construe s.36 so as to extend its scope to produce a quasi-regulatory system which the Act expressly provides for, with all the necessary powers and safeguards, in another part of the Act....

[T]he elimination of ... monopoly rents is (otherwise than by competition) within the province of Part IV of the Act.”

Thus part IV of the Commerce Act provides for regulation of prices for the purpose of reversing exploitation of consumers. The Telecommunication Act 2001 can be argued to have a similar focus (particularly in view of the Act’s explicit rejection of the efficiency-oriented Baumol-Willig Rule and support for cost-based pricing).

Paragraph [56] of Professor Katz’ evidence seeks to place a gloss on US regulatory policy that might seem to equate it with New Zealand’s. Enforcement is not pursued “simply” because of wealth transfers. Quasi-rents (monopoly prices in the short run) are not illegal and have been recognised as legal by the Supreme Court. US competition policy focuses on blocking actions that would harm competition.

So far so good. But then Professor Katz adds that “it does so because harm to competition would be expected to lead to harm to competitors”. Precisely so: there is no incompatibility between a policy objective of driving out monopoly rents and one of promoting efficiency. In principle both policies will reach the same end-point.

Paragraph [57] is a mere play on words. Paragraph [58] is another exercise in logic rather than direct analysis. Professor Katz says that the *Draft Report* “apparently” thinks that distributional concerns arise under regulation but not under general competition policy. He unfortunately provides no citations to the alleged Commission position, but simply says that the alleged distinction “makes little sense as a matter of economics”. This may well be correct – the two policies pursue essentially the same outcome, and there is no necessary incompatibility between them. The issue is not, however, one of substance in the present case.

Professor Katz then embarks on a series of sentences which presumably look superficially supportive of the rhetorical position of Telecom, but in fact say nothing of substance. Again the structure is “if... then...” “If the political decisions has been made not to count wealth transfers as a net benefit in one case [competition policy], then I am unaware of any economic rationale for treating the other case [regulation] differently”.

And in [59]: “if the public policy objective is to promote efficiency, then it is incorrect to assert that finding competition to be limited somehow justifies pursuing regulatory policies with the objective of reducing profits or transferring surplus from producers to consumers”. The logic here seems wrong – limited competition and monopoly profits do tend to go hand in hand, whence both efficiency and transfer-oriented policies will work towards the same outcome. The remainder of the paragraph merely warns against suppressing profits beyond the “functionless rents” threshold, since positive margins “can serve socially useful functions by providing incentives to undertake costly and/or risky investments”. Professor Katz wisely does not proceed to any claim or suggestion that the Commerce Commission is unaware of this basic point, or that its *Draft Report* in some way reveals ignorance of it.

The last paragraph of the section, [60], points out that it is wise for policymakers to be cautious. Again Professor Katz makes no suggestion (other than possibly by imputation) that the Commerce Commission has in any way failed the test of caution.

Overall Part IV.C of Professor Katz’ report fails in its declared objective of promoting understanding of the consumer welfare standard relative to the promotion of competition. The section repeatedly resorts to setting up false dichotomies in order to create the impression that some deep and irreconcilable tension exists between regulation using the consumer welfare standard and competition-promotion with an efficiency goal. As I have shown earlier in this report, there is no necessary incompatibility whatever – the two objectives, properly understood, are entirely consistent with each other.

In Part V Professor Katz turns to a series of direct criticisms of the *Draft Report*. His first area of concern, part V.A, relates to the separability of policies targeting income distribution and those targeting efficiency. The discussion in this section is confused by a persistent failure to distinguish between income-distribution concerns at society-wide level, which are appropriately dealt with by tax-transfer policies, and those associated with monopolistic distortion of a particular market, where wealth transfers are inextricably bound together with economic inefficiency and where, consequently, successful pursuit of the efficiency goal will generally deliver also the desired distributive outcome, with no need for supplementary tax-transfer policies to be implemented. The quoted passage from a Treasury briefing of 2004 reveals essentially the same confusion of thinking; Treasury appears to have missed the simple point that “concerns about distribution of income” are legitimately divided between those concerns which will be satisfactorily resolved by market-specific efficiency-oriented regulation, and those which must be pursued on a wider canvas.

The suggestion that an appropriate division of labour would involve splitting-off all income distributional policies from regulatory policy is incoherent because it fails to recognize the appropriate classification of distributional concerns between those that are best solved in tandem with the pursuit of economic efficiency, and those which are best attacked separately through a separate policy programme.

In paragraph [67] Professor Katz returns to his “if...then” mode. Having noted that it is completely reasonable for policymakers to adopt income distribution and fairness as policy objectives, he produces the statement that “If the intent of the Telecommunications Act 2001 is for regulation to promote efficiency or to maximize the long-term benefits that end-users derive from mobile telecommunications services, then the approach taken in the *Draft Report* is incorrect.”

Paragraph [68] is far more substantial, as well as badly confused. Here Professor Katz begins by pointing to the need for some system of welfare weights to aggregate the possibly-competing interests of various parties, and criticizes the Commission for weighting all consumers equally. He then asserts a logical inconsistency where none is apparent. The passage reads:

If all individuals get equal weight in their role as consumers, it is logically inconsistent to assert that the *same people* should be treated differently in their roles as the owners of telecommunications carriers.

The alleged inconsistency is merely asserted., not demonstrated. No logical inconsistency is to be seen unless somewhere at the beginning of the argument a hidden premise has been inserted which states that individuals with multiple roles must be treated exactly equally in all roles. Certainly economic theory contains no such

proposition. It is common for economic analysis to differentiate individual agents according to the different roles or functions they fill.

The paragraph concludes with a further non-sequitur: “If the *Draft Report* were consistent, it would conclude that wealth transfers ... should not be considered a benefit of regulation”.

Paragraphs [69] and [70] then suggest that the Commission, in its treatment of transfers, is somehow trying to achieve a distributional goal of favouring the less-wealthy against the wealthy: the view attributed to the Commission here is that “wealth transfers from producers to end-users should be counted as a benefit of regulation because they redistribute income from the wealthy to the less wealthy”. I can find no statement to this effect in the *Draft Report*, and I very much doubt that Professor Katz would be able to point to any Commission document that has used this particular argument. In fact I note that in the last sentence of paragraph [70] Professor Katz himself concedes that “the *Draft Report* points to no such determination.

These two paragraphs are in fact no more than diversionary exercise, demolishing a convenient, but merely straw, target. They contribute nothing to the central issues in the present case.

Part VI, containing Professor Katz’s critique of the Commission’s methodology, lies outside the scope of this report.

## 6. Vodafone

I turn now to the submission of Vodafone. I note that Vodafone’s consultants, Frontier Economics, in an appended report entitled *Response to Issues in the NZCC Draft Decision on Regulation of Mobile Termination*, set out in paragraphs 13 – 24 an attack on the Commission for “seek[ing] to elevate the benefits to a particular class of consumers above those [*sic*]of benefits that accrue to society as a whole.” The “appropriate basis on which to assess the impact of the intervention is to review the public benefits or economic efficiency expected to be generated.”

The remainder of Frontier Economics’ argument is premised upon this view that the test ought to be a public-benefit one rather than a consumer-welfare one. At no point do the consultants engage with the wording of the relevant legislation. Instead they offer a fairly tendentious summary of what they consider economic theory says in the distinction between efficiency and equity, and engage (paragraph [18]) in the familiar but unhelpful device of purporting to see in the Commission’s approach some ideological predisposition in favour of consumers being treated as “particularly deserving compared with those from whom the dollars are transferred.” At paragraph [22] Frontier even asserts that “a consumer surplus standard is contrary to the standard principles of

economics”. Not only is this incorrect (as I have noted earlier, economists are well equipped to analyse the consequences of any policy rule once that rule has been specified, but do not have a mandate to dictate which rule is appropriate); even if correct it would not provide an argument for the Commission to reject the legislative mandate it has been given.

Vodafone devotes paragraphs [368] to [385] of its evidence to the treatment of transfers, largely echoing Frontier Economics’ line. In [369] it offers the opinion that “counting transfers as benefits is contrary to standard principles of economics”, and in subsequent paragraphs it seeks to give some substance to this claim. Vodafone claims also that the consumer welfare approach is “at variance with the approach the Commission normally adopts”, which suggests some lack of familiarity with the relevant legislation and the distinctions drawn there between authorization cases and control investigations.

At [370] Vodafone stakes out an extremist stance: “The concerns about monopoly are economic concerns, not issues of distribution”. The dichotomy is, of course, a false one, and the claim that monopoly raises no distributional concerns is equally incorrect.

Subsequent paragraphs are disjointed and often seem confused. [371] denies that margins of price over cost can reliably be used to identify monopoly profit; [372] suggests that price control denies investors a return on risk; and [374] accuses the Commission of inconsistency, completely overlooking the existence of different regulatory criteria in different passages of the legislation. Paragraph [376] asserts that “economics normally treats a dollar as being worth a dollar regardless of whose hands it is in”. As I have already shown, this is not a matter of economic principle but merely a rule of thumb, which should not be taken out of context as Vodafone does here.

Paragraphs [381] and [382] follow Telecom’s practice of making no distinction between the criteria laid down in the legislation for authorization hearings and those to be used in control cases. Paragraph [384], similarly, assumes the existence of a simple “orthodox” view on transfers from which the Commission has strayed by misinterpreting Parliament’s statutory wording.

Overall Vodafone’s submission adds nothing of substance to the arguments of Telecom. Vodafone misconstrues the approach of economic theory to monopoly, and reveals poor knowledge of the legislation.

In particular, Vodafone joins Telecom in arguing that the principle of separability in economics somehow renders monopoly profits immune to regulatory interference. This recruitment of “economic theory” to shield excess profits by blocking regulators from capping monopoly prices and/or revenues involves a complete mis-reading of what economic theory actually has to say in this area.

## **Concluding Remarks**

Obviously if a policymaker starts from some economy-wide redistributive goal, then economics would advise using tax/transfer mechanisms to implement the policy, rather than introducing tax and subsidy instruments to distort prices in individual markets in pursuit of the distributive goal. This is the separability-based grain of truth from which the Telecom-Vodafone argument starts.

But when a policymaker starts with the desire to correct market distortions due to the exercise of monopoly power in some particular market, it is ludicrous to argue that because a competitive price would leave consumers better-off than under monopoly, somehow the regulator's hand should be stayed, for fear of encroaching on the work of the distributional arm of government.

No economic principle insists on such an absurd demarcation rule. The regulator's task is to promote the efficient working of the market mechanism by neutralizing the exercise of market power. The reversal of monopoly-derived rent transfers is one of the several benefits of effective price regulation, and is to be welcomed and credited as such. A major detriment caused by the monopolization of any market is the stripping away, as monopoly rents, of consumer wealth which otherwise would be allocated to the purchase of goods and services in other markets. The restoration to consumers of this purchasing power has important effects for both equity and efficiency, and amounts to affirmation of the consumer's right to be protected against predation.

Monopoly, in short, is corrosive of consumer sovereignty. Framing the distributive issue in terms of the "wealthy" versus the "non-wealthy", as both Telecom and Vodafone have sought to do, completely misconstrues what is at stake. Economics has a long history of support for consumer sovereignty and competitive markets. Regulation of monopoly around the world has always had, as one of its central motives, the desire to prevent those with market power from using it to distort both prices and wealth distribution away from the pattern that would prevail under competitive conditions.