NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Commerce Commission's Draft Reconsideration Report on Mobile Termination Services

May 2010

1. Introduction

1.1 This submission on the Commerce Commission's 12 May 2010 Draft Reconsideration Report (DRR) recommending the designation of mobile termination access services is made by the New Zealand Business Roundtable, an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

2. Background

2.1 This long drawn-out saga has consumed enormous public and private sector resources, most importantly the diversion of time of executive resources. The Commission opened its formal investigations of the case for designating mobile termination in May 2004. In August 2005 the government asked it to reconsider its June 2005 designation recommendation. In April 2006 the Commission again recommended designation. In April 2007 the government rejected this recommendation and accepted deeds of agreement offered by Vodafone and Telecom. These deeds provided specified prices for mobile termination services through to March 2012. However, in May 2008 the Commission informed interested parties that it was considering yet another investigation into regulating mobile termination. It released an issues paper in August 2008 and announced the start of an investigation on 6 November 2008. Telecom and Vodafone offered new undertakings on 12 January 2009 and revised undertakings on 6 May 2009. 2degrees offered an undertaking on 22 December 2008 and Vodafone has made it clear that it felt obliged to offer 2degrees especially favourable terms in order to help it enter the market. On 30 June 2009 the Commission announced that it was recommending regulation of mobile termination and the rejection of these undertakings. On 22 February 2010 the Commission's Final Report recommended acceptance of new undertakings by Vodafone and Telecom as an alternative to regulation. In April this year Vodafone launched a new Talk Add-on product and the Commission subsequently invited the Minister for Communications and Information Technology to take account of this product in assessing its recommendation. On 26 April 2010 the Minister asked the Commission to consider whether any subsequent retail offers might affect this recommendation. The Draft Reconsideration Report considers that its recommendation is indeed affected.

3. The lack of a national interest justification for the latest recommendation

3.1 We made our first submission on these issues in November 2004 and our last submission was in July 2009. Throughout we have been greatly concerned about the implications for investment in infrastructure of the never-ending litigation and re-litigation of pricing issues. It is clear that currently incumbents can have no certainty as to future pricing plans even if they have reached firm deeds of agreement with the Crown. We have long considered that there should be a presumption in favour of protecting private property rights in infrastructure investment, unless a clear-cut case indicating material net benefits to the community from regulation can be made.

3.2 The DRR makes no attempt to establish net benefits from its proposed regulation. It does not even revisit the calculations of net benefits in the February 2010 Final Report. For example, paragraph 778 in that report considered that the gain in consumer and producer surplus over five years from FTM regulation might be $44 million, *compared to the prices permitted to 2012 under the earlier deeds*. Such a gain would be trivial when spread over 1.6 million households over five years – just $5.50 per year per household on an undiscounted basis. Regulatory authorities should not be recommending regulation for small and speculative gains. The majority view of the Commission was not to recommend regulation, primarily because of a judgment that even such meagre net community benefits could be more cheaply obtained under the new undertakings (see paragraph 829 and table 31). So exactly why does a further lowering of prices to end users suddenly make the community worse off relative to the regulatory alternative?

3.3 According to the DRR, Vodafone's Talk Add-on product represents a considerable reduction in what it charges per unit to Vodafone customers who use pre-paid phones to call other Vodafone customers. According to Vodafone, it will also lower use-related charges for mobile calls to landlines. Nothing in the DRR suggests that Vodafone would be seeking to charge its customers more in other ways in order to compensate for the reduced revenue per unit. It would appear therefore that, at an unchanged volume of calls, this is a net transfer of surplus from Vodafone to its customers, due presumably to competitive pressures. Prices overall continue to fall. So where is the harm to the community?

3.4 The Commission considers that this innovation will oblige a particular competitor to lower its end-user charges similarly and thereby incur a loss (see paragraph 62 of the DRR, table 4 and appendix 2). It implicitly acknowledges that such a transfer of surplus does not, in itself, harm the community overall. Instead it fears that the result of the assessed harm to the competitor's producer surplus "may be longer-term detrimental effects on competition in the mobile services market". The Commission has now turned the issue into an argument about predatory competition. The proposition is that by lowering its retail charges while maintaining its wholesale termination charges, Vodafone is making it more difficult for a new entrant to compete. Indeed, it may be doing so, but if the new entrant is doing its job it will be also making it more difficult for Vodafone to compete. Competitive pressures work in both directions and neither aspect, in itself, imposes a harm on the community overall. Indeed, it is in the public interest that incumbents do compete vigorously with new entrants, as long as they do not abuse a dominant position.

3.5 The crux of the Commission's national interest case, to the extent that it has one, must be that Vodafone is lowering end-user charges relative to costs this year with the expectation of being able to raise them in some subsequent year and, as a result, seeking to damage or drive out a competitor and discourage future entry. A valid predatory pricing argument relies on this ability to recoup opportunity losses during the period of predation. How likely a scenario is that in New Zealand's circumstances? The DRR makes no case that it is plausible and presents no calculations of how much higher Vodafone's charges to end-users might have to be in future years in order to offset the opportunity losses in the intervening period. A plausible argument needs to be made because of the obvious difficulties Vodafone would face in attempting to recoup losses from predatory pricing due to customer resistance, new technologies, unforeseen changes in market conditions, unpredictable competitor responses, and future Commerce Commission surveillance. It is for such reasons that economists are commonly sceptical of predatory pricing arguments, and uncomfortable when antitrust legislation is used to force prices to end-users up rather than down.

3.6 Instead of adopting the above national interest perspective, the Commission focuses on the objective of ensuring that incumbents preserve the profitability of new entrants by maintaining an adequate *margin* between the retail prices charged end-users and the wholesale prices that a new entrant would be charged for calls that its customers make which terminate on the incumbent's network (see paragraph 142). Clearly this is not in itself a national interest argument. The DRR's supplementary proposition is that regulating wholesale termination charges down to 'the' assessed cost "will best promote competition in the relevant downstream markets", apparently without the need to regulate retail prices (eg paragraph 18). This is potentially a national interest argument but it is a different argument and if it were valid, why did the Final Report in February find net benefits in favour of *rejecting* such regulation? After all, the Commission makes no case that assessed wholesale termination costs have altered materially since its Final Report.

3.7 The DRR's answer to this question in paragraph 31 is that it only recommended against regulation in the Final Report because it thought competitive pressures would *not* force retail prices down both absolutely and relative to wholesale charges to the extent that is now in prospect. In order to stop this relative fall it now favours regulation.

Clearly this is likely to be seen as retail price regulation from the perspective of incumbents. From the Commission's point of view it would presumably be more accurately described as margin regulation since the Commission would surely not be averse in principle to margin-preserving reductions in wholesale and retail prices. Yet mathematically, when three variables (wholesale price, retail price and the margin), are linked by an identity, only two of them are independent. Regulation of the wholesale price, together with an ongoing regulatory interest in the margin, implies an ongoing regulatory interest in the retail price. The incumbents would have a point in seeing this as retail price regulation.

3.8 To sum up, the Commission's central concern in the DRR appears to be to preserve the profitability of the new entrant *per se*. It sees no need to make a case that Vodafone's new retail plan is predatory – that opportunity losses now can be handsomely recouped in future. This implies that its goal is not a national interest objective. But if it is not a national interest objective, what is it? *In our view it is essential that the Commission in its final report either presents a compelling national interest justification for its recommendation, along the lines required in a Regulatory Impact Statement, or changes its recommendation.*

4. Would regulation of wholesale charges protect new entrant profitability anyway?

4.1 The analysis in section 3 suggests that the DRR's central concern is to regulate wholesale termination rates in order to preserve a margin of profitability for the new entrant. But would it achieve this goal? Surprisingly, is not clear from the information made publicly available that this will be the case. For example, the analysis in table 4 in the DRR is only partial. It does not inform readers what assumptions are being made about changes to other sources of revenue or about consequential competitive market adjustments to other charges. For example, what is the Commission assuming would happen to revenues from fixed line calls that terminate on the new entrant's mobile network?

5 Are calculations of costs valid for regulatory purposes?

5.1 There is a strong presumption in the DRR that the costs of mobile termination services can be objectively determined notwithstanding the analytical problems of joint products, common costs, transaction costs, the subjectivity of differing views about how the future will unfold, and the optimality of transactions at disequilibrium prices, as part of the discovery process, which induce dynamic entry and exit. Costs can never be determined objectively: they reflect subjective entrepreneurial views (about risk for a start). The DRR states that if wholesale charges are to be regulated, all parties have agreed that cost-based regulation will be the most efficient. However, the conditional 'if' is very important in this statement. It would be wrong to infer from this statement that there can be any precise agreement, even amongst a cross-section of independent experts, as to the quantum of those costs. Given the two-sided nature of these markets and the options for recouping costs by cutting and dicing a segmented market in many ways, how healthy competitive forces would actually split the charges through time between different services and different customers is probably impossible to determine outside the confines of an over-simplified model. It is disturbing that there is no acknowledgement in the DRR of the problematic nature of price regulation in such circumstances. Such uncertainties should be acknowledged in any national interest assessment of the case for price regulation.

5.2 Another concern is that there is always a danger with price regulation of regulatory capture – that the regulator will regulate so as to protect the profitability of a new entrant that the regulator has at an earlier time encouraged implicitly or explicitly to enter the market. The Commission needs to show much more clearly that it is alert to this concern.

6 Conclusions

6.1 The Commerce Commission should either provide a compelling national interest case in its final reconsideration report for recommending regulation, or change its recommendation. It needs to do so because the goal of protecting the profitability of any competitor is not a valid national interest goal in itself and the DRR fails to establish that it is a valid goal in this particular case. It does not even demonstrate convincingly that regulation would achieve that invalid objective.

6.3 As in the past, we submit that for reasons of dynamic efficiency and the protection of property rights there should be a rebuttable presumption in favour of preserving the liberty of those who have invested irreversibly in infrastructural assets to price them as they see fit. In our view the Commission should interpret the dynamic efficiency requirement to mean that in general it should apply the burden of proof against the case for intrusive regulation.