NZ's tilted playing field

Louise Longdin, Senior Lecturer in Law, University of Auckland, looks at the issues still facing New Zealand seven years after privatisation

Although it is now seven years since New Zealand's telecommunications industry was exposed to full private and largely offshore ownership and an ultra light-handed regulatory regime, it must be said that it remains a far from ideal model for other countries contemplating privatisation.

Indeed, in *Telecom Corporation of New Zealand v Clear Communications Ltd (1994)*, the Judicial Committee of the Privy Council delivered a thinly veiled criticism of the New Zealand Government's experiment which leaves the dominant player, Telecom Corporation of New Zealand, and new entrant competitors free to negotiate 'in a fog' all the terms and conditions of access to the national fixed public service telecommunications network (PSTN) which is owned by Telecom and which serves 93 per cent of all residences and virtually all businesses.

All new providers of fixed or mobile telecommunications services require access to the PSTN finding it wholly impractical and uneconomic to duplicate. There is still no immediate prospect of any new entrant being able to by-pass the need for access to the PSTN by using fibre optic cable. New Zealand's leave-it-largely-to-market-forces approach, moreover, leaves Telecom sitting on monopoly profits which, while currently invisible to competition law scrutiny, may well be both large and durable.

When the state-owned enterprise Telecom Corporation of New Zealand was privatised in 1989, no provision was made for statutory rights to interconnection nor were guidelines given as to the terms and conditions on which a person who owns an essential facility is to give access to someone else who is not only a consumer but a potential competitor. Nor was any specialist independent body such as the Australian AUSTEL or British OFTEL created or charged with dealing with the situation where Telecom and a hopeful new entrant fail to agree on interconnection costs. Telecom's conduct was made subject only to the checks and balances outlined below:

1. **The application of ordinary competition legislation.** Section 36(1) of the Commerce Act 1986 prohibits abuse of a dominant market position. Its thrust roughly equates to section 46 of the Trade Practices Act 1974 although the New Zealand test for dominance is somewhat higher than the Australian.
2. **Telecom's undertaking** given in 1989 to the New Zealand Government by the chairman of the newly privatised Telecom that it was 'Telecom's policy to ensure that interconnection will be provided to competitors on a fair and reasonable basis, and the relationships between Telecom companies will not unfairly disadvantage competitors'. This may, if breached, provoke a political or legislative response from the Government but is unlikely to be enforced through the courts.
3. **Statutory machinery for price control.** Part IV of the Commerce Act 1986 provides that the Governor-General may impose price controls for goods or services in circumstances of restricted competition. These provisions have never been activated.
4. **Telecom's Kiwi Share Obligation (KSO)** contained in Telecom's Articles of Association provides that Telecom must not increase, in real terms, the standard residential rental provided that the overall profitability of Telecom's subsidiary operating companies is not 'unreasonably impaired'. Telecom must also provide and maintain rural residential lines at a cost no higher than the standard residential rental. The KSO, with its provision for an untimed 'free' local call option, can only be enforced by the Minister of Finance on behalf of the Crown.

In hindsight, it would have been sensible to create some mechanism for measuring the actual costs of fulfilling this universal service obligation. In *Telecom Corporation of New Zealand v Clear Communications Ltd* the Privy Council alluded to the sheer difficulties faced by Clear Communications who were required to prove on the balance of probabilities, in an action for abuse of dominant market position against Telecom, what Telecom's true costs were and that Telecom did not make, as it alleged, a loss on its residential and rural services which it had to cross-subsidise from its business and other customers. While such investigations into costs are, as the Privy Council said, 'the daily diet of a regulatory body', New Zealand has no such independent body to assist to this end.

Another serious criticism of the KSO is that the Government has never really addressed the political or economic issue of what is the most appropriate mechanism for funding or charging for any welfare element inherent in the KSO in a fully contestable market. At present, Telecom is picking up the tab for any such welfare element, if it exists, and the unlegislated *quid pro quo* is that Telecom is sitting on monopoly profits which may well be competed away only very slowly or not at all.

5. **The Telecommunications (Disclosure) Regulations 1990** which were designed to constrain Telecom by making it disclose certain information to its consumers and competitors. They require Telecom to publish separate, audited financial statements for its regional subsidiary operating companies as though they were independent and unrelated companies. Moreover, they require Telecom to publish its standard contract terms and conditions and details of discounts granted in excess of 10 per cent. Significantly, the regulations do not require Telecom to disclose all terms and conditions of the arrangement it finally negotiated with Clear to allow it access to the PSTN after a strong response to the Government discussion paper, *Regulation of Access to Vertically-Integrated Industries*, published in August 1995 after the Privy Council decision prompted the Government to threaten intervention unless Telecom entered into an access arrangement quickly. The Telecom/Clear arrangement will not necessarily assist Bell South or any other new player who has to negotiate the cost and terms of their own access to the PSTN with Telecom.

The Privy Council found that the so-called Baumol-Willig (or Efficient-Component Pricing) rule was an adequate basis for interconnection pricing in a perfectly contestable market apart from the risk of monopoly rents. The rule was originally designed as the basis for fair competition, to avoid breach of section 36 by Telecom, not to regulate prices. In their joint brief, Professors Baumol and Willig postulated that in an industry such as telecommunications which enjoys economies of scale and scope, the proper yardstick is a fully contestable market rather than a market full of competitors. Thus in such a fully contestable market, if Telecom sold to a competitor the facilities necessary to produce a service that Telecom could otherwise provide, Telecom would not be abusing its dominant market position if it demanded a price equal to the revenue it would have received had it provided those facilities itself. That is to say, Telecom is entitled to its lost 'opportunity costs' assessed on the basis of regular reviews. (Telecom had conceded that necessary periodic adjustments would have to be made in the assessment of the lost opportunity costs.)

Professor Baumol has twice expressed strong concern about the application of his rule in the New Zealand context. First, after the New Zealand Court of Appeal rejected his rule, he observed in a joint article with J. Gregory Sidak of Yale School of Management that:

The efficient component-pricing model plays its full beneficial role only when adopted as part of a set of complementary rules designed to promote consumer welfare. One such rule is that a monopolist should not be permitted to charge a high price for a final product sold to consumers that is higher than the price that would attract an efficient entrant into the market - a price equal to the stand alone cost of producing the final product.

He also stressed that:

> 'The real problem is that the [Telecom] has been permitted to charge monopoly profits for the final product in the first place. Had the ceiling upon final product prices been based on the stand alone cost, which ... it should be, [Telecom] could never have earned a monopoly profit in this regulatory scenario. The error, therefore, is the failure to impose the stand alone cost ceiling on the final product price, not the use of the efficient component-pricing rule.'

In the result, New Zealand's experience of telecommunications privatisation where new entrants seek access to an essential facility owned by a vertically integrated monopoly not formally regulated by any government body is one that does not deserve emulation. The intended 'level playing field' is still tilted seven years after privatisation. ❑