NEW ZEALAND INSTITUTE FOR THE STUDY OF COMPETITION AND REGULATION INC.

SEPARATING NEW ZEALAND'S INCUMBENT PROVIDER

A Political Economy Analysis

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CORPORATE MEMBERS
Contact Energy Ltd
Fonterra Co-operative Dairy Group Limited
Meridian Energy
Powerco
Telecom Corporation of New Zealand Ltd
Transpower New Zealand Ltd
Vector Ltd
Victoria University of Wellington
Westpac Institutional Bank

OVERVIEW

Separation policy: the theory

Separation in New Zealand: the practice

Analysis

- the policy process
- the political economy

SEPARATION: THE THEORY

Separation of a ‘bottleneck’ asset into a stand-alone firm

- transparent transacting with firms buying services using the bottleneck (regulatory advantage)

Promises a “level competitive playing field”

- limits ability of firm with market power in upstream market to discriminate in favour of its own downstream operation (Cave, 2006)

Spectrum

- accounting to full ownership (Cave, 2006)

BUT

Costly, risky, radical
- not to be undertaken lightly (OECD, 2003)
- either voluntarily or by regulation

Costs
- large in magnitude
- wide-ranging in effect (Xavier & Ypsilanti, 2004)

Benefits
- highly uncertain (Xavier & Ypsilanti, 2004)
- difficult to quantify (Crandall & Sidak, 2002; Cave, 2002, OECD, 2003; Crandall, 2005)

Irreversible (Xavier & Ypsilanti, 2004)

JUSTIFICATION

Should only be undertaken when

1. All other possible regulatory options have been eliminated ***AND***
2. Cost-benefit analysis clearly demonstrates net positive benefit (Xavier & Ypsilanti, 2004' de Bijl, 2005)
   - metric is increased total long run welfare/efficiency (sum of consumer and producer welfare)
     - dynamic and static
     - relative to integrated counterfactual

Mere presence of a bottleneck or risk of discrimination alone is insufficient (de Bijl, 2005)

- must take account of incentives to invest in future networks that will bypass the bottleneck

NZ – THE TIMELINE

1980s: deregulation and corporatisation

- separation eschewed – efficiency imperative
  - impending privatisation – scale and scope economies led to higher price upon sale

1990s: privatisation and competitive entry

- ‘light-handed’ regulation – efficiency prevails
  - pragmatic response to costs of industry-specific regulation in country of 4 million
- ‘the’ court case Clear v Telecom 1991-94
  - allegations of exercise of market power
  - eventually (Privy Council) found in favour of Telecom
  - substantial competitor dissatisfaction
- political pressure to resile from ‘light-handed regulation’
  - initially resisted
  - but change of government in 1999

NZ – THE TIMELINE (cont)

2001-2005: Industry-specific regulation

- Telecommunications Commission
  - efficiency imperative in Act
  - backed up by cost-benefit analyses
  - determinations prioritised dynamic efficiency (LLU, 2003; Mobile Termination 2005)
- Commission recommends, Minister must accept or reject
  - LLU recommendation accepted – politically unpopular
  - first mobile termination recommendation rejected – returned to Commission for re-evaluation
  - second mobile termination rejected – Ministerially-brokered agreement

NZ – THE TIMELINE (cont)

2005 General Election commitments

- "advancing policies to ensure that the telecommunications sector becomes more competitive" replaces efficiency directive

2006 'The Stocktake'

- led by Ministry not Commission
- no principled theoretical or empirical assessment, cost-benefit analysis on any of the issues considered
- imposed mandatory LLU – separation only proposed as a secondary measure if LLU failed to deliver increased competitiveness
- very superficial analysis of separation costs, benefits
  - main emphasis on non-discrimination benefits
  - but increased costs heralded if imposed unilaterally

NZ – THE TIMELINE (cont)

18 December 2006 – amendments to Act passed

- no change from May proposals
  - separation legislation enables activation at a later date
- despite voluntary proposal by Telecom to separate wholesale and retail

April 5 2007 – Minister announces mandatory separation will begin immediately

- 11 months ***BEFORE*** first unbundled loop sold
- ‘Separation Day’ will be March 31 2008 (two weeks after first unbundled loop actually sold)

May 31 2007 – Minister announces he and not Commissioner will lead separation process

- reflecting “urgency attached by the Government” and assessment that it was a “major structural issue and not a matter of micro-regulation”

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THE PROPOSAL

No principled theoretical or empirical analysis of separation proposals

- 76 page discussion document
- two pages address benefits of separation
  - all but one paragraph addresses separation as a tool to pre-empt discriminatory behaviour
- one sentence addresses costs of separation
  - “these potential effects do, however, need to be considered in light of potential disadvantages associated with vertical separation, such as loss of vertical integration scale and scope economies and an increase in the transaction costs of dealing between internal business units”

TELECOM'S RESPONSE

Plan rigid, unworkable, unable to be delivered in proposed timeframes

- given simultaneous requirement to unbundle, build NGN
- insufficient technical expertise to do three tasks; all delayed

Failed to address need for regulatory certainty

Returns too low and risks too high to engender investment

- would only invest $0.5 billion of $1.5 billion necessary for building the network envisaged in the Government's digital strategy (the NGN)
- threat made credible on May 3 when firm returned $1.1 billion from the sale of Directories business to shareholders

Made voluntary offer conditional on regulatory changes

STANDOFF MAY TO OCTOBER

Minister refused voluntary proposals

- final determination released September 27 contained no material changes to April proposal

Telecom refused to commit to NGN investment

October 27 Telecom announces it will invest $1.4 billion over 5 years to build NGN

- original plans were for NGN to be operational in 2008

Ten days later Commissioner announces final LLU prices will be between 14% and 20% higher than those proposed

ANALYSIS - PROCESS

Should be undertaken only when

1. All other regulatory options have been eliminated
   AND
2. Cost-benefit analysis demonstrates net positive benefit
   - even taking account of negative investment incentives where bypass networks exist

New Zealand case provides a poor precedent for a principled policy-making process

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COSTS & BENEFITS: competition at what price?

As predicted, costs high, certain and irreversible

- shareholder wealth destroyed
- fixed costs to implement $300 million
  - total extra entrant investment from LLU Stocktake regulations anticipated at only $200 million
  - equivalent to 10 months broadband connection fee for 1 million consumers (BT separation costs equivalent 1 months connection fee)

Benefits???

- entrants already have access at TSLRIC cost prices
  - if no bypass, then extra costs passed on to consumers
- bypass already present
  - all bypass operators vertically integrated
  - will imposing higher costs on Telecom than competitors face increase competition?

HOW CAN THE PROCESS BE EXPLAINED?

POLITICS

Pursuit of competition replaces pursuit of efficiency as prevailing sector objective at 2005 election (election promise to “make the market more competitive”)

- ‘competition’ is a poor proxy for ‘efficiency’ when scale is important (Alleman & Rappoport, 2005)
- but
  - ‘competition’ is more tangible and easier to explain to voters than ‘efficiency’
  - structural changes provide more tangible evidence of strong action undertaken taken than allowing markets to evolve (e.g. letting unbundling be tried first)

MORE POLITICAL ECONOMY

Incremental interventions begin from change of Government in 1999

- political distancing from progenitors of the ‘light-handed’ regimes (1984-99)
- interventions intensify as government majority narrows

Ministerial rather than Commission control from 2005

- “efficiency” directive remained in the Act
- Commission bound to undertake CBA
- but Ministry not bound by same obligation
    - Stocktake and Separation undertaken from an ideological rather than an empirical perspective
    - Ministry personnel ultimately accountable as agents of the Minister
    - but what about their agency relationship as ‘public servants’?
- hence independent Commission sidelined to avoid the costs of political intervention becoming tangible?

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CONCLUSION

Poor processes lead to poor (and potentially very costly) policy

- separation is costly and irreversible; imperative that adequate analysis is undertaken before it is imposed

NZ's separation process has deviated substantially from the principled processes advocated in the theory

- driven by political rather than economic imperatives
- very costly consequences have ensued
- benefits very hard to identify let alone quantify

Hence not a good process to model other separation decisions upon