



**NEW ZEALAND INSTITUTE FOR THE STUDY  
OF COMPETITION AND REGULATION**

# **COMPETITION AND GOVERNMENT NETWORK SUBSIDIES: Enemies or Allies?**

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Presented at the Düsseldorf Institute for  
Competition Economics

October 22 2013

## **CORPORATE MEMBERS**

Contact Energy  
Fonterra Co-Operative Dairy Group  
Meridian Energy  
Powerco  
Telecom Corporation of New Zealand Ltd  
Victoria University of Wellington  
Westpac Institutional Bank

“If it moves, tax it.  
If it still moves, regulate it.  
If it stops moving, subsidise it.”

Attributed to former United States President Ronald Reagan

And if all else fails, nationalise it?



# AGENDA

1. A little regulatory history
2. A little subsidy story
3. A giant problem
4. Lessons from New Zealand



# 1. A LITTLE REGULATORY HISTORY



# NEW ZEALAND: A MARKET TO WATCH?

## 1987

First country in the OECD to rely primarily on Competition Law to govern network industries

- including privatised former government firms: telecoms, electricity, railway, airline, airports

But not an ‘unregulated Wild West’

- special provisions for dominant firms (Part IV, Commerce Act 1987)
- contractual undertakings between government and newly-privatised firms
  - e.g. ‘Kiwi Shares’ for Telecom, Air New Zealand



# OBSERVATIONS

Not clear that it was less efficient (both statically and dynamically) than industry specific regulation

- in Telecoms, at least
  - Ministerial Inquiry (2000), Howell (2007)

But industry-specific regulation introduced anyway

- claim: to make the market ‘more competitive’
- but statutory effect was to constrain the dominant firm
  - Telecommunications Act 2001
    - names firm to be subject to regulation (Telecom/Chorus)
    - prescribes regulated products and pricing methodologies (including the network on which they are offered)
    - single nationwide focus



# REGULATORY RATCHETING

2001 – interconnection, wholesale access to voice products

- data regulation eschewed due to extant and expanding infrastructure competition

2004 – bitstream unbundling

- interim measure as incumbent planned nationwide FTTN (2007)

2006 – full local loop unbundling (‘ladder of investment’)

- market not ‘competitive enough’; FTTN behind schedule
  - broadband connections exceeded target by 11%, but only 25% sold by competitors – competitors promise ‘ladder’ investments

2007 – functional separation

- before first unbundled connection sold



# INVESTMENT STRIKE

2007 (June)

- FTTN investments delayed by regulatory activity
- incumbent will only provide \$500 million of estimated \$1.5 billion under current regulatory arrangements
- threat made credible when \$1 billion returned to shareholders





# A NEGOTIATED SOLUTION

2007 (November)

- Government announces incumbent undertaking to supply FTTN network connecting all communities with more than 500 lines to minimum 20 Mbps broadband speeds by 2011

2007 (December)

- copper access prices revised upwards

FTTN delivered 'on time' (by 2007 timetable) and on (2007) budget



## 2. A LITTLE SUBSIDY STORY



# NEW ZEALAND: A MARKET TO WATCH?

## 2008 General Election

National Party-led minority government promises

Government-subsidised 'nationwide' FTTH network

- 75% of residences to have access to 100Mbps by 2018

Delivered by Public-Private Partnerships (PPPs)

- Government funds \$1.5b of \$4 to \$6 billion project
- 'capital recycling' model

Criterion for participating:

- full structural separation of network and retail operations
- including copper network if incumbent is a partner



# 'JUST BUILD THE NETWORK'

2008 – policy announced

2009 – Crown Fibre Holdings established to oversee PPPs

– September 2009 draft terms released

- 33 separate geographic areas; G-PON; open access Layer 1 dark fibre; structurally separate network firm (including incumbent's copper network if it is a successful tenderer); 'capital recycling' model

2010 January 29 – tenders close

– 33 respondents – incumbent but no other telecoms market participants

- despite having around 50% share in mature broadband market
- and most having infrastructure investments (backhaul, etc)



# 'JUST BUILD THE NETWORK' (cont)

2010 July 8– change to tender rules announced

- open access to bundled Layer 1 and Layer 2
- only existing tenderers could resubmit
- 'winners' recommended to Parliament in late October

2010 September 9 – preferred partner for 24% of project (18% of national broadband market announced)

- NOT THE INCUMBENT!

2010 October 15 – submissions due on revised Telecommunications Act

- identity of successful fibre tenderers, not deemed relevant
- only 'problem' was how to set copper prices if Chorus was a tenderer

# 'JUST BUILD THE NETWORK' (cont)

2011 May 24 – remaining 'UFB Partners' announced

- Chorus the partner for only 70% of project (50% of addressable broadband market); different rules (more risk)
  - Chorus gets Auckland (population 1.5 million => no infrastructure competition)
  - competitor contracts for many small towns (e.g. Hawera, population 11,500) => FTTN, fibre infrastructure competition
  - Christchurch (earthquakes Feb 22 2011, Sep 4 2010) goes to competitor => new copper connections (plus competing DOCSIS-3.0 connections) relaid in areas not covered by immediate fibre build plan

2011 June 30 – assent of revised Telecommunications Act

- only substantive change is 'retail minus' copper prices replaced by benchmark, TSLRIC



# AT A REALLY 'GOOD' PRICE

Chorus had absolute cost advantage (FTTx network)

Crown Fibre let contracts in two stages to ensure Chorus 'sharpened its pencil'

- substantial share of contracts (24%) let pre-emptively early to non-Chorus bidder to signal willingness to strand Chorus FTTx investments if tendered price not 'right'
- but never likely that Chorus would not get a significant share of the build
  - total cost otherwise would have been very much higher
  - and would have guaranteed aggressive price competition from copper against fibre, undermining fibre project



# EARLY SUCCESS?

“One of the rewarding things about our UFB programme has been the high levels of international praise for how our roll-out is progressing, particularly compared to some of the other international programmes”

Communications Minister Amy Adams, 8 August 2013

- 20% of network built
- but less than 3% uptake by premises passed
- “by comparison, in Singapore uptake was about 2 per cent when 20 per cent of the network was built and in the UK, uptake was about 3 per cent when 24 per cent of the network was built”
- Japan? Korea?





# 3. A GIANT PROBLEM



# WHAT MS ADAMS DIDN'T SAY

## An industry in near complete disarray

- impasse as draft regulatory decision on future copper access price (proposed 30% decrease for unbundled bitstream) threatens business case for fibre investment
- collapse in the share price of (separated) copper incumbent Chorus
- international capital flight from Chorus (from 75% to around 45% of shareholding in less than five months)
- threatened government override of regulatory decision
- consumer (and voter) backlash at denial of (possible) lower copper prices if government intervention occurs



# HOW DID IT COME TO THIS?

To an economist, the answer is simple

No clear competition policy

No consistent regulatory framework

- because how can you regulate anything when you don't know what the you are trying to achieve?

Many different regulatory silos

And no cohesive policy oversight to prevent the debacle



# FIBRE SUBSIDIES: A 'SOLUTION' LOOKING FOR A 'PROBLEM'

'Missing market' for investment? **NO**

- 2007 NGN undertaking between Chorus and Government
  - all communities with 500 or more lines would have access to 20Mbps by December 2011

International envy? **PROBABLY!**

- keeping up with the Jonses/Kims/Watanabes (Australia/Korea/Japan) in the 'fibre arms race'?
- a “step change in the provision of broadband services” delivering economic growth, productivity improvements and “increase(ing) New Zealand’s global competitiveness, particularly compared to other OECD countries”  
Communications Minister Steven Joyce, 2010

Political motivations? **UNDOUBTEDLY**



# BUT THAT DOES NOT EXCUSE BAD POLICY

How did policy-makers allow this to occur?

Why did they not 'see it coming'?



# REGULATORY SILOS: FIBRE

“Crown Fibre Holdings monitors compliance with the terms of the Ultra-Fast Broadband Initiative while the network is being built. This includes oversight of price caps, products, network construction and operation (especially quality assurance testing), as well as the Government’s investment in shares, financial instruments and governance.”

» <http://www.crownfibre.govt.nz/publications/regulatory/>

“The Commerce Commission monitors and enforces the deeds of undertakings made by the government’s Ultra-Fast Broadband partners, as well as other aspects of the Telecommunications Act 2001”

» Ibid



# REGULATORY SILOS: COPPER

“We have no statutory role in promoting or protecting fibre,” says Gale. “Our task in this larger project is just to fix the price of copper-based services. Retail service providers will then compete on whatever network they find most profitable.”

Telecommunications Commissioner

- » <http://computerworld.co.nz/news.nsf/news/new-wholesale-price-for-access-to-copper-network>



# WHO GOVERNS THE BROADBAND MARKET?

Irrelevant when the overriding purpose (and statutory context) of regulation is to **constrain the enduringly dominant firm, not oversee the development of competitive interaction** within a market

- hence Telecommunications Act 2001
  - names the firm and the network being regulated
  - specifies the products
  - identifies the pricing methodologies to use
  - instructs the Commissioner to get on with it
  - and specifically prevents
- does not allow for
  - management of infrastructure competition
  - transition of dominance between firms





# SUBSEQUENT REGULATIONS

Bolted regulatory artefacts onto the 2001 architecture

- assuming enduring dominance by the regulated firm
- even though local infrastructure competition already present in some (retail) markets

In this view,

- Chorus will be enduringly dominant in copper markets
- UFBCos enduringly dominant in fibre markets
- only relevant market is the wholesale one
- therefore no ‘problem’
  - equivalent access (promoting services competition on each infrastructure) is sufficient for normal competitive interaction to drive fibre uptake



# AND IT MIGHT HAVE BEEN ...

Except that when one of the networks is subsidised, the regulated prices (on the subsidised network at least) can **NEVER** be cost-based!

- UFBCo (nationwide) fibre ‘prices’ set in 2010 so as to be ‘competitively neutral’ with prevailing (nationwide) wholesale copper prices (so not cost-based at all)
- any change to the copper price destabilises the ‘artificially competitive’ balance between networks
  - when instigated by the regulator meeting statutory obligations, is in effect the government breaching the PPP agreements



# SUBSIDY MOTIVATION NOW CRUCIAL

Fibre investment to provide infrastructure competition to copper

⇒ falling copper price no 'problem'

⇒ except that taxpayers will pay more for fibre network as substitution delayed (capital recycling will not occur, loans to Chorus not repaid)

Fibre investment to facilitate rapid substitution from copper to fibre

⇒ falling copper price a real problem

⇒ prolongs life of copper network; delays revenues to be accrued from fibre network; exposes Chorus to additional financial risks

⇒ and devalues compensation paid to copper operator for abnormally early closure of the network (in those areas where copper operator is not the UFB partner, at least)



# REVISITING THE PPP CONTRACTS

Bid prices based on equalised copper and fibre prices for equivalent services when bids called in early 2010

## Non-Chorus bidders

- no existing market participant apart from the incumbent bid
- price bid unequivocally subsidised network build cost only

## Chorus

- bid price is build cost plus compensation for regulatory takings for forced early closure of copper network as a consequence of government fibre investment
- will differ depending upon how much of the addressable market and in which areas Chorus expects to get contracts

# THE COMPETITIVE REALITY

## At least 6 different market structures

- areas where government fibre will not be deployed (30% of market) – copper must endure indefinitely
  - with and without other effectively competitive infrastructure (satellite, LTE, etc)
- fibre areas (75% of market)
  - Chorus supplies copper and fibre => short term infrastructure competition, cut rapid substitution and decommissioning copper (70% of the fibre market, 50% of broadband market)
  - Chorus supplies copper and competitor supplies fibre => enduring infrastructure competition
- both of above, with and without infrastructure competition (cable, rival fibre, LTE etc)



# ONE COPPER PRICE TO RULE THEM ALL?

Which of the six markets is the single price set to calibrate?

- one single nationwide copper price will be ‘wrong’ for at least 5 of the 6 markets

December 3 2012

- Commission proposes internationally-benchmarked copper access price
  - 30% lower than 2010 prices used when setting fibre bids
  - unilateral breach of good faith w.r.t. PPP contracts
    - will delay fibre uptake rate => non-Chorus firms will not meet rollout targets as capital will not ‘recycle’ as fast as expected
    - devalues Chorus’ compensation for ‘regulatory takings’



# GOVERNMENT BREACHED PPP TERMS

Chorus, other investors legitimately believed the government would not allow copper prices to deviate from early 2010 levels

Regulator's actions have led to government breaching PPP agreements

Government could have intervened immediately

- threatened, but no action until February 8 2013
- ‘action’ turned out to be ‘inaction’
  - a regulatory review, which was not begun until August 2013
- result was collapse in Chorus share price, foreign capital flight
  - investing in NZ ‘too hard/too risky’
  - Government ‘can’t be trusted’



# PROPOSED 'REVIEW SOLUTION'

Set (single, nationwide) copper price using 2010 fibre bid price as the cost of an equivalent modern network as per TSLRIC

But which fibre price?

Chorus price (including compensation for early closure)?

- 'wrong' price for non-Chorus fibre areas (too high)

Non-Chorus price

- 'wrong' price for Chorus fibre areas (too low)

Any fibre price

- 'wrong' for non-fibre areas
  - crowds out future copper investment
  - wrong price signal for other entry (e.g. LTE)





# WHAT CAN BE DONE NOW?

More patching of 'bad existing regulation' not an option

- must start with a clean slate
- governing today's markets, not yesterday's or 'tomorrow's'
- but forward-looking so adaptable to changing circumstances

Separate geographic markets regulated according to current competitive realities

- incentives to achieve government policy objectives can be calibrated differently for different competitive environments

Government buyout of all private investments so taxpayers, not investors, bear risks of (poor) government policy-making (the 'Australian' solution)???



# 4. LESSONS FROM NEW ZEALAND



# SUBSIDIES AREN'T SIMPLE

Subsidies really are the enemy of competition

Subsidised fibre networks do not descend into a competitive vacuum

- will always override property rights in extant networks
  - primarily copper, but what about cable, satellite, fixed wireless etc?
- necessarily invoke issues of compensation for regulatory takings
  - ignore them at your peril!



# WHAT CAN EUROPE LEARN?

State Aid rules make an NZ-type outcome less likely

- but any state subsidy alters incentives

Any State investment must be addressing a specific market ‘problem’

- clarity of objective, ensuring consistency of competitive interaction and policy objectives are non-negotiable’
  - investing just to ‘get a fibre network’ is not sufficient

When regulating for infrastructure competition

- separate geographic markets are unavoidable if appropriate incentives are to be applied across all networks and all operators



# WHAT CAN EUROPE LEARN (cont)?

Path dependency influences regulatory frameworks

- risk of ‘frame blindness’ must be overcome

Regulators are ultimate custodians of sector strategy

- may be strongly influenced by integrated incumbent firms
- structural separation disincentivises sector participants from taking responsibility for sector strategy
  - missing market for co-ordination
  - increases responsibility for regulators, policy-makers for determining direction

Beware of doing deals with governments!



# THANK YOU



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