

## **Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill**

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### ***I INTRODUCTION***

The Telecommunications (TSO, Broadband, and Other Matters) Bill (the Bill) and the Supplementary Order Paper (SOP) seek to fundamentally change the regulation and development of the telecommunications industry in New Zealand. This paper outlines the ACT Party's position and is to be tabled as a minority report alongside the report of the Finance and Expenditure Committee.

### ***II PRINCIPLES***

At the last election the Government promised to invest in New Zealand's telecommunication infrastructure, in particular UFB. The UFB objective is "to accelerate the roll out of the [UFB] to 75% of New Zealanders over 10 years, concentrating in the first 6 years on priority broadband users such as businesses, schools and health services, green-field developments and certain tranches of residential areas".<sup>1</sup>

The central question for the ACT Party is whether in principle we support the UFB initiative. It is the ACT Party's strong belief that this Bill should not pass in its current form. As with all significant interventions, the onus is on the Government to show that the investment of taxpayers' money is warranted and beneficial for New Zealand. The greatest flaw with this Bill is that it lacks vital information to make an informed decision. There has never been a wide economic analysis done on the Bill by Treasury. This Bill has been driven by a political imperative rather than an economic one. The lack of a cost-benefit analysis means that there is not the information present for anyone to make a decision. In this case it should not be supported. Roger Kerr has succinctly highlighted the flaws with the Government's approach to this Bill:<sup>2</sup>

The taxpayer is forking out \$1.5 billion for an investment which shamefully has had no cost-benefit analysis conducted on it... Moreover, a major recent study was unable to find any significant additional economic benefit from moving to speeds higher than we have at present. That is not to say that we should not invest for faster broadband but it does indicate that we should only do so off the back of a full economic justification and not with the poor old taxpayer's money again put at risk with a modern unjustified version of Muldoon's Think Big projects.

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<sup>1</sup> NZ Government UFB Initiative, Invitation to Participate in Partner Selection Process (October 2009) at [1.1]

<sup>2</sup> Roger Kerr "The Truth about Privatisation: Blog #6" Roger Kerr (8 March 2011).

To embark on major infrastructural development based on very little economic analysis is reckless at best. In the absence of such analysis it is difficult for any side to determine whether there is going to be real return for taxpayers. On this point alone, we urge the House not to support the Bill.

### ***III DOES THIS MAKE SENSE?***

The reality is that the telecommunications industry is a network industry. It is inevitable that the Government has some role to play in regulation. The issue is whether this Bill enhances the goals that we as New Zealanders would like to see in the telecommunications industry. The central goal that the ACT Party is concerned about is enhancing efficiency in the industry. Does this Bill seek to further this end? Simply, it does not. There are four major reasons in support of this conclusion.

#### ***A Picking Winners - The Fatal Conceit***

First, the Government is once again looking at entering into the telecommunications market with both money and heavy-handed regulation in order to try and actively pick future technology winners with taxpayers' money. New Zealand and Australia are guinea pigs in going down a government-determined UFB path. That alone should worry us. There may be a case for government involvement as it is a network industry but this Bill imposes a singular future on a complex industry.

The central difficulty with Government investment in this area is that there is a need for significant investment coupled with a high commercial risk.<sup>3</sup> The development and use of UFB in the future is not a *fait accompli*. If it were, the risk calculus would heavily favour private investment. It is possible that the next generation of wireless networks could potentially deliver the speed of UFB and on that basis alone we do not consider that UFB is necessarily the future of telecommunications in New Zealand.<sup>4</sup>

If the Government is wrong and technological developments favour other ways to provide internet there is a large opportunity cost for New Zealanders. This opportunity cost is borne out in two ways. First, in a static sense \$1.5 billion dollars has been invested in a way that has a low return. If the money was left in the hands of private individuals they could seek out more productive investments leading to greater prosperity for New Zealand as a whole. Second, in a dynamic sense, there is an opportunity cost for future development in the telecommunications industry.

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<sup>3</sup> Submission to the Finance and Expenditure Committee by Telecom on the Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill (11 March 2011) at [42.1] and [42.2].

<sup>4</sup> Meeting between Ross Young and Liesbeth Koomen of TelstraClear and Hugh McCaffrey and Michael Bridge (1 April 2011).

This Bill means that New Zealand companies have been artificially incentivised, due to the Government subsidy, to invest in the roll out and development of a technology that may become increasing irrelevant.<sup>5</sup> This might be particularly true for the fibre to the home aspect. This approach will set us down the road of path dependency. Once the network has been built, path dependence will ensure it keeps on being used and developed because the fixed costs will be much lower. This occurs because the set of decisions that one faces in the future are limited by the decisions made today. This hinders the long-term development within the telecommunications industry to the detriment of all.

It is certainly possible that the Government might be able to pick winners in private industry. However, this is to engage in the fatal conceit. Price signals are the only means to enable the communication of dispersed knowledge between each other in society. We should be wary when we see statements such as this from Telecom to the Finance and Expenditure Select Committee (FEC):<sup>6</sup>

UFB requires private organisations to commit to significant investments with no certainty of return. Private investors, and the capital markets that fund them, will reflect this risk in the costs of capital they apply to their UFB investments. The uncertainty around the return on and of capital will in turn affect private organisations' initial pricing models for UFB investments...

The uncertainty in the capital markets talked about by Telecom, which means that investment in UFB at present is not worth it for private investors, should be a strong signal to vote against this Bill. Is there some piece of information known only to Government which means that it is any less risky for them to put in such a large amount of capital? The Government has not established the case.

#### *B Low-Value Return?*

Second, it may be that this investment will produce low-value returns for New Zealand. New Zealand Institute's director Rick Boven has warned that New Zealand may get very little benefit from faster broadband. He believes that New Zealanders should take advantage of current technology and infrastructure and should not wait for high speed internet to change the way they operate.<sup>7</sup> This is not to say that UFB infrastructure upgrades will not be valuable in the future, it is just that right now its impact on New Zealand may be negligible. This is important to consider in deciding whether the Government makes any capital outlay now. There might be an argument to make that the cost-benefit

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<sup>6</sup> Submission to the Finance and Expenditure Committee by Telecom on the Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill (11 March 2011) at [44].

<sup>7</sup> New Zealand Herald "NZ 'not ready for fast broadband'" (14 April 2011). Rick Boven, however, is in support of improving infrastructure as he believes there is an important link between developing and fostering networks and high-performance economy.

analysis over a short-run analysis (the 8½ years it will take it to build the infrastructure) may be positive in the light of possible technological developments in that timeframe. However, there is too much uncertainty around the benefits that this will bring to New Zealand. It is unclear whether New Zealanders are actually utilising telecommunications infrastructure to its capacity at present. In the event that they are not, any additional investment is likely to have low returns. Moreover, the regulatory concessions, offered in addition to public funds, will allow the new Local Fibre Companies (LFC) to engage in anticompetitive behaviour. While the regulatory holiday may expire in 2020, by that time inefficient market structures and behaviours will be entrenched. In this sense, any short term return will be outweighed by the medium-long term impact on competition.

### *C Infrastructure into New Zealand*

Third, the actual roll out of the fibre may be ineffective without further investment. This Bill proposes to push fibre optic networks to most homes in New Zealand. This will greatly increase the Baud Rate at which we can access the internet (Baud rate is the amount of 1s and 0s that can go through a line at any given time.) This is fine, but upgrading the lines from the house to the exchange is only one part of the solution. Unless the lines going in and out of New Zealand are upgraded to match this new capacity, then we could be wasting our time. There is no point in having a great capacity within New Zealand if the feed into New Zealand cannot match it. This warrants a closer look. Once again the analysis provided is scant on detail.

The heart of the problem here is that there is not enough information present to determine whether this project is a waste of money or not. The Government has moved quickly to implement an election promise and have not been able to produce the evidence that favours support for the proposal.

### *D Forbearance*

Fourth, of all the ways to incentivise investment a regulatory holiday is generally considered to be bad practice. Simply, a regulatory holiday allows those who receive it to do something that they would not otherwise be allowed to do. Often this will be at the expense of the end-consumer.

In terms of the cost of the initial outlay of cable, it will cost the Government \$1.350 billion with private investment of \$400 million. This is a total cost of \$1.750 billion for the fibre cables to be laid. A key initiative to lower the risk to private investors is to implement a regulatory subsidy in the form of a forbearance period in return for the \$400 million investment. The forbearance period means that Government-funded fibre services get a 10-year regulatory 'holiday' from Commerce Commission oversight. This regulatory holiday prevents the Commission from recommending price/non-price

regulation for access to UFB services. This would be in effect until the end of 2019.<sup>8</sup> It is argued that without the forbearance period the private sector would require a further Government contribution of \$400-600 million. This additional outlay of capital is not something the Government is willing to bear.

In terms of the outlay of fibre, the Government seems to be holding most of the risk while granting major benefits to private companies. The Government has moved to grant LFCs and their investors the benefit from ownership of new monopoly-like services, a \$1.350 billion investment of public funds into their network, and major public sector contracts (in health and education). The central question here is whether the Government is being ripped off by the lack of regulation for the forbearance period.

There are only two ways in which the regulatory subsidy could change the risk calculus so that it lowers the risk for private investors. First, it allows infrastructure owners to price above competitive levels. It seems that for a regulatory holiday to be of value to investors, it usually has to allow for those investors to make a higher return on their investment. By limiting the role of the Commission the Government transfers value to infrastructure owners at the expense of end users by requiring consumers to pay higher prices.<sup>9</sup>

The Government argues that the contract between the LFC and the Crown Fibre Holdings will regulate the price, meaning that there is no opportunity for end-consumers to face high prices. It is certainly true that the Government will regulate the price through contract. However, through mutual agreement the prices set in year one can be changed. Access seekers (those parties that then purchase UFB off LFCs) are not party to such contracts and therefore have no say in the price or any recourse if prices change. It seems perfectly consistent with Government-legislated monopolies that the LFCs could through contract set the price very low, creating a large uptake in consumers of UFB, and then move in year 5 or 6 to vary the contract with the Crown to maximise their profit at the expense of consumers. The question here is one that turns on political reality. Is it likely that the Government as a partner to these contracts would be willing to raise prices to end-consumers? Initial indications suggest that LFCs are insisting on retaining the right to increase prices and change services.<sup>10</sup>

Conversely, another problem is that prices could be set artificially low in the first place, to the detriment of competitors. In competition law this is generally referred to as predatory pricing and is a misuse of market power. In this case, the government has entered the market and proposes to change

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<sup>8</sup> Submission to the Finance and Expenditure Committee by TelstraClear on the Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill (11 March 2011) at [36].

<sup>9</sup> Ibid at [40].

<sup>10</sup> Letter to the Finance and Expenditure Committee from Liesbeth Koomen, Telstra Clear (6 May 2011).

the law to benefit itself and its co-investors. New Zealanders cannot expect a government entity to act in a commercial way.

Second, the value of the regulatory holiday might simply be to give certainty over prices so that they will remain constant (or at least not decrease). If this is the value, then there are potentially more straightforward alternatives. Certainty here could be provided by upfront regulation. This could be done by an undertaking to the Commission as part of their normal regulatory process, or by simply having the Commission regulate the price in the first place, or by the Government just paying an extra \$400 million or so to get rid of the forbearance period altogether.<sup>11</sup> However, there is legitimate concern that the Commission may indeed intervene and regulate over the top of any contractual agreement. The question must turn on whether we value that oversight in this industry.

The most concerning aspect of the forbearance period stems from the path-dependency analysis above. A regulatory holiday until 2020 allows LFCs to set up and start conducting their business in a way that is not subject to the Commission. Once on the path, the cost of change is significant. After 10 years, when the Commission can step in, the standard for conduct in the industry is likely to have been set and ingrained. The Commission has a difficult decision to make, either to intervene and try and unscramble the egg which would create greater uncertainty, or to leave those standards in place at the expense of long-term efficiency in the industry. It is important to set a new industry on the right path rather than try and change it ten years down the line. It is for this reason that the European Union does not permit regulatory holidays to be awarded and that no other jurisdiction has enshrined a regulatory holiday in legislation.

It is not within the scope of this paper to argue over whether there should be a role for the Commerce Commission in setting price in network industries now. Here it is assumed that there are compelling arguments for the current Commission involvement in telecommunications. Recent examples include the High Court fining Telecom \$12 million for anticompetitive behaviour; the Commission's discovery that Telecom has overstated its regulatory financial accounts by \$1billion; and the recent decision on mobile termination (this is the type of decision which the Commission will be banned from even considering for broadband over fibre). From this position it makes it difficult to hold that there should be a total exclusion of the Commission from UFB.

We should all be concerned about the future competitiveness of the telecommunication industry. The Government is moving into a position where it is a major financier, an owner of assets, the regulator and rule-setter, as well as being a significant customer of telecommunication services. The

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<sup>11</sup> Ibid at [62].

Government has the ability to shape the industry through its purchasing choices, which means that there is a real question for private investors about whether they should put their money into their networks or into lobbying.<sup>12</sup>

## V *ALTERNATIVES*

The ACT Party would not recommend investment by the Government, however if you are going to invest there may be other options:

- 1) True Open Access – the development of our network by new consumers taking up the service. This means that the costs involved are met as they sell to consumers. This would be akin to the way Sky TV boxes have been distributed.
  - a. This would maximise competition without the need for heavy handed regulation.
  - b. The Government has said that without the regulatory holiday it will cost at least another \$400 million dollars. There is so much uncertainty around the regulatory holiday that it may well be desirable to spend the \$400 million up front in order to get rid of the regulatory holiday and allow for greater competition in the future.
  - c. This was a problem that Sir Roger Douglas faced in the steel industry in the 1980s. It was better to pay \$2 billion dollars up front so that the large tariffs could be abolished and to allow greater competition into the industry. This is akin to this situation.
- 2) Abolish the TSO requirement for Telecom - 1 and 2 are not mutually exclusive.
  - a. This would allow costs to fall where they should ending the practice of a cross-subsidisation from urban to rural areas.
  - b. In addition, it would force other technological development to solve the problem (such as wireless, discussed above).
  - c. It is not clear that there is a good case for mandating any form of universal service. There are no comparable mandates for many other goods and services (eg electricity and transport) that are delivered to remote consumers. The cross-subsidies that arise result in a misallocation of resources at the margin and reduce the economy's growth potential.<sup>13</sup>
  - d. As part of this, the ACT Party would advocate getting rid of the 'Kiwi Share' and free calling requirements. Foreign ownership restriction may impose economic costs and stop benefits accruing to Telecom. The normal investment rules should apply.

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<sup>12</sup> Submission to the Finance and Expenditure Committee by Vodafone on the Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill (11 March 2011) at [6].

<sup>13</sup> Letter to the ICT Regulatory Group, Ministry for Economic Development by Roger Kerr, New Zealand Business Roundtable (29 October 2010) at 2.

- e. Finally, to be consistent with this principle, the Bill should not overturn the Commission's previous decision to set different prices to access the unbundled copper local loop in urban and non-urban areas. Again, the Commission should be left to do its job.
- 3) A Special Access Undertaking (SAU) as an alternative to the regulatory holiday. It could provide certainty to those investing in UFB, including Telecom— but also provide certainty to those that expect to buy UFB. It also allows the Commission to do its job.
- a. An SAU is a written undertaking in which the provider undertakes to comply with the terms and conditions specified in the undertaking in relation to the provisions of access to access-seekers.
  - b. The SAU is a concept that was introduced into the Australian regulatory regime for telecommunications in 2002. Under the regime, a person who is, or expects to be a telecommunications service provider may give an SAU to the Australian Competition and Consumer Commission (ACCC) in relation to any telecommunications service, provided that the service has not yet been 'declared' by the ACCC (i.e., subjected to access regulation).
  - c. Regulatory certainty could be provided to the access provider by ensuring that an approved SAU prevails over any subsequent attempt to regulate prices. At the same time, however, regulatory oversight of prices can be maintained by allowing the Commission to review and approve price terms when it considers a SAU.

While the ACT Party disagrees with Government investment, if they are to proceed we support points 1 and 2 above as they are most likely to facilitate an open market in the telecommunications industry without heavy regulation.