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**TOWARD COMPETITION IN
NEW ZEALAND TELEPHONY**

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ABSTRACT

Dramatic changes have occurred in the telecommunications sectors of most industrialised countries over the past decade. So too have their regulatory and government policy environments in the worldwide trend towards deregulation and open competition. The New Zealand market is now claimed to be the most deregulated, open, and competitive in the world with all government-imposed barriers having been removed.

An economist's Utopian vision for telecommunications would be a set of highly competitive markets, subjected to very minimal interference, to enable the full impacts of technological change or demand variation to be reflected in market adjustments. Ideally, telecommunications would be a dynamic and demand-responsive industry subject only to the restrictions of capital and consumer markets.

Progress towards a fully competitive telecommunications industry was *never* anticipated to be simple. The effectiveness and appropriateness of New Zealand's general competition legislation, namely the *Commerce Act 1986*, has regularly been called into question. One is often reminded of the Commerce Commission's gloomy conclusion in 1992 that reliance upon the *Commerce Act* "may be of some help - but of a protracted, expensive and uncertain kind, and with definite limitations on its scope" (Commerce Commission, para. 437, 1992). The battle towards open competition in New Zealand telecommunications has clearly been impeded by the application of 'light-handed' regulation with primary reliance on the country's general competition legislation. New Zealand's experiences provide valuable lessons for other countries, in particular, the danger of placing too heavy a reliance on the judicial system operating under the country's general competition legislation, as industry regulators. In New Zealand, competition has become something akin to an ideology - a complete faith that if a market is structured so as to involve multiple participants, competitive conduct will result to bring about superior, efficient performance. We can but hope, that as competition becomes more widespread in all telecommunications markets, its real benefits in terms of overall economic efficiency, will indeed accrue to all sectors within society.

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INTRODUCTION

Over the past decade, dramatic changes have occurred in the telecommunications sectors of most industrialised countries. Explanations for such changes include a surge in demand for new, more sophisticated and enhanced communication tools combined with general advances in and the convergence of telecommunications technology.

Throughout that decade, the industry both within New Zealand and overseas, has experienced major reforms in both its regulatory and government policy environment. The worldwide trend towards deregulated and openly competitive telecommunications markets has been led strongly by New Zealand. There have been claims that the New Zealand market is now the most deregulated, open, and competitive in the world, with all government imposed barriers having been removed.

The changes made to the regulatory environment governing telecommunications in New Zealand markets have been radical, but have been consistent with the economic reforms undertaken by government since 1984. New Zealand government policy has assumed an entirely new direction with a shift away from strict interventionism towards a more liberal approach, with the main aim being to "create a more open, competitive, market-led economy and hence establish the necessary conditions for faster economic growth, a higher level of employment and ultimately a more secure and equitable social welfare system" (Boston and Holland, 1987, p 7).

The extent to which such dramatic changes in the environment impact on the industry's organisational structure and degree of competition is an interesting and crucial issue. Such importance has prompted interesting and controversial questions of whether the regulatory framework and structural characteristics present in New Zealand telecommunications actually facilitate or obstruct the economic forces of competition from having their full impact on the market.

An economist's Utopian vision for telecommunications would be of a set of highly competitive markets in which very minimal interference exists. This structure would be expected to enable the full impacts of technological changes or demand variations to be reflected in market adjustments. Ideally then, it would be a dynamic and demand-responsive industry, subject only to restrictions imposed by capital and consumer markets. However, the situation encountered by the New Zealand telecommunications industry diverges greatly from this ideal, and as a result has presented various problems for which solutions are crucial if real competition is to thrive and bring benefits to all. Instead of aspiring to, and achieving the competitive ideal, New Zealand's telecommunications industry faces one fundamental problem. Telecom, as the incumbent industry monopolist, has essentially assumed the role of de facto regulator since it owns and controls the essential inputs, and by and large, despite its claims to the contrary, makes the rules under which competition is permitted to take place. This problem raises issues with regards to the effectiveness of New Zealand's legislation governing competition, calling into question the role of s.36 of the *Commerce Act 1986* in resolving disputes concerning the use of a dominant market position.

The purpose of this thesis is to explore the changes to the economic and regulatory environment and their impact on the New Zealand telecommunications industry over the past decade, including an historical survey of the progress towards open competition. One of my objectives in undertaking this research is to present a clear and accurate account of the developments in telecommunications to date, and of the problems and impediments to that development which have been experienced. It is important to bear in mind that although this work is specific to the New Zealand telecommunications industry, it examines issues and problems, mainly with regards to access, which are not unique to this country but are faced by telecommunications and other similar network industries worldwide. Where that network has the characteristics of an 'essential facility' whereby duplication of that facility is not economic, if competition is to emerge it may be necessary for entrants to gain access to the incumbent's network, but the incumbent has an obvious incentive to place difficulties in the way of entry.

This research into the New Zealand telecommunications environment is of great value, for although it has been claimed that this market is nominally the most deregulated, open, and competitive in the world, events to date have cast doubt on how much competition there actually is. For example, the lengthy litigation between Telecom and Clear has not yet resolved the terms for Clear's access to Telecom's network for local service, and the government has issued a last warning to the parties that it may be forced to intervene to broker a settlement. Instead of the industry restructuring which has occurred facilitating the development of competition, what appears to have evolved is an industry still confronted by underlying impediments and constraints on competition. This research will explore these issues and problems, their impact on competition, and what policy options are available to the government to overcome them.

In essence, the overall objective of this thesis is to present an historical survey of the deregulation of the New Zealand telecommunications industry, and to examine the difficulties which have impeded the emergence of competition. This objective is to be accomplished by an examination of each step on the path towards deregulation in telecommunications, viewed against the background of the economy-wide liberalisation programme.

A brief outline of the contents of each chapter is as follows:

Chapter 1 sets the scene for New Zealand's economic policy 'revolution' and outlines the economic reforms which were introduced in virtually all sectors in New Zealand during the 1980s. The new free market philosophy behind those reforms present a stark contrast with the previous highly interventionist economic policies followed during the Muldoon era and before. The reforms were characterised by the removal of statutory barriers to competition, the corporatisation of public sector trading activities, and a reliance on 'light-handed' regulation as a means of deterring anti-competitive behaviour by dominant firms.

Chapter 2 then proceeds to account for the widespread State involvement historically in trading activities in the New Zealand economy, ranging from airlines to banking, and from steel to forestry. A major factor was that the State was viewed as an important agent for economic development.

Particular attention will be paid to the development of telecommunications under exclusive State ownership prior to 1987, in order to provide the background for the analysis of subsequent developments in the industry.

Chapter 3 focuses on the Government's policy of corporatisation and the various rationale for its implementation. The structure of State trading enterprises shall be explored here to highlight the specific characteristics thought to be impeding their performance.

Departments were made into corporations owned by the Crown, with managers responsible to largely independent boards of directors and the prospects for improved performance are discussed. The process of policy implementation through the *State Owned Enterprises Act 1986* is described. This Act was implemented to put State trading departments on a commercial footing in the pursuit of business objectives.

It was intended that the restructuring of State enterprises would remove the characteristics, as identified in the previous chapter, which were thought to be impeding their performance. In the forefront were 'principal-agent' problems, which arose because of the lack of clear objectives and management accountability inherent in the government department structure. Former departments were run by State servants as agents of the State, but multiple and conflicting objectives, hidden subsidies and constraints, political interference, and other factors reduced their effectiveness. It is likely that the corporatisation alternative solved many, but not all, of these problems.

Chapter 4 examines the specifics of how corporatisation was implemented in telecommunications, and its impact on the former State monopolist. The concurrent programme of industry deregulation designed to progressively remove barriers so as to phase in competition is also outlined..

Subsequent attempts to enter into the market, not all successful, are described here. Telecom's adjustments to the prospect and actual new rivalry are explored, including the company's strong improvements in productivity and responsive to consumer demand.

Chapter 5 contains an examination of the general rationale for privatisation, such as the benefit from eliminating residual 'principal-agent' problems inherent in the State corporation model. The implementation of the privatisation of Telecom is then considered.

The 'Kiwi Share Obligation' (KSO), under which specific obligations for supply and price are imposed upon Telecom, is outlined here. This Obligation presents an important stumbling block in Clear's negotiations for local access with Telecom.

The organisational structure and policy changes made by the new owners are detailed here, as well as the initial effects of the privatisation on Telecom's operations.

Chapter 6 considers the extent of the natural monopoly characteristics of telecommunications and the regulatory problems to which this gives rise.

The emergence of 'light-handed' regulation of dominant firms in New Zealand is discussed. We define the key elements of this form of regulation, and then contrast it other forms of regulation of utilities or essential facilities. A contrast is drawn between light-handed regulation and the more 'heavy handed' regulatory approach of an industry-specific regulator, Austel in the case of telecommunications, as adopted in Australia.

The three elements of light-handed regulation in New Zealand are:

- reliance on the *Commerce Act 1986* to promote competition;
- information disclosure regulations to make transparent the operations of dominant firms; and
- the threat of price control for non-compliers under *Part IV* of the *Commerce Act 1986*.

Each of these elements shall be examined in order to assess their effectiveness in the New Zealand telecommunications industry.

Chapter 7 presents an overview of the experience of the 'light-handed' regulation of telecommunications in promoting entry of competitors during the period 1990-95. This will cover the litigation and arbitration to date, together with the Commerce Commission Report on Telecom of 1992 and will also introduce the combined Ministry of Commerce and Treasury Discussion Paper on this issue published in August 1995. I also mention the long-awaited agreement between Clear and Telecom regarding local service interconnection which will be further addressed in Chapter 9.

Chapter 8 delves into the contentious issue of obtaining access to an incumbent's network, which has been the major constraint on the development of competition in New Zealand local telephony. The key issues are the price and terms of interconnection. The technical aspects of interconnection are also addressed in order to give the background required for assessing these issues.

The 'Baumol-Willig rule', or the Kahn 'Competitive Parity Principle' is one pricing rule offered to provide theoretical guidance on the issue of interconnection to the network. The rule is assessed in terms of its ability to promote efficiency, fairness and competition. This rule is favoured by Telecom but opposed by Clear, which has suggested alternative pricing formulae. The rule was recently upheld on appeal by the Privy Council, New Zealand's highest court, but the courts are not price fixing authorities, and so the onus remains on the parties involved to negotiate the terms and conditions of access.

We examine the three principal criticisms which have emerged concerning this pricing principle to provide the balancing opinion and assess their sustance.

Both Baumol and Kahn have questioned, in light of New Zealand's 'light-handed' regulatory framework, whether the rule can work effectively in a market lacking price control to moderate monopoly profits. The government's concern at the delays in reaching a settlement, has culminated in a report from officials about the options for further regulation, particularly under the provisions contained within *Part IV* of the *Commerce Act*.

Chapter 9 presents the major conclusions and recommendations of the August 1995 combined Ministry of Commerce and Treasury Discussion Paper on vertically-integrated natural monopolies. We then proceed to examine, perhaps motivated by the threat of those recommendations, the interconnection agreement for local service between Clear and Telecom concluded on 4 September 1995. This eventual agreement provides the ideal conclusion to this thesis but of course, the success and commercial feasibility of it remains to be seen over the next five year contract duration.

Chapter 10 presents a final Summary and Conclusion, and overviews the salient findings in each of the preceding chapters, assesses the extent to which competition has been promoted by the reforms in this industry, and comments on likely future development.