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Commerce Act Review
Ministry of Economic Development
PO Box 1473
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By Email: commerceactreview@med.govt.nz

Dear Sir/Madam

Review of Regulatory Control Provisions under the Commerce Act 1986

Vodafone appreciates the opportunity to continue to be involved in the Ministry of Economic Development's (the Ministry's) ongoing programme to improve the working of the Commerce Act. Quality regulation is an important part of an environment that encourages investment and growth. Investment in infrastructure can increase productivity and raise living standards for all New Zealanders.

The current review of the legislation is significant for the telecommunications industry for at least two reasons:

- There are implications for the telecommunications regime – although Vodafone generally falls under the provisions of the Telecommunications Act 2001 for regulation of the nature discussed in the Ministry's discussion document, the Commerce Act has a strong influence on telecommunications regulation. In its report on the Telecommunications Amendment Bill in 2006 (No 2), the Finance and Expenditure Committee noted that the Ministry would be considering the issue of merits review in its work on the Parts 4, 4A and 5 of the Commerce Act. The committee suggested that the Ministry revisit the issue of merits review in the context of the Telecommunications Act following that piece of work.
- There are some direct parallels – For example, we have also been involved in extensive debate with the Commerce Commission (Commission) and the industry on the appropriate test to use when considering regulation in telecommunications. The same issues arise in the Commerce Act review.

In light of the above, we confine our comments here to the accountability issues raised in the document and to the issues of the goals and tests for regulation more generally.

Chapter 1: Introduction

Question 1: Do you have any comments on the desirable characteristics of a regulatory regime as outlined in this Chapter?

The desirable characteristics all seem very reasonable. However, we wonder whether the list should also include a statement that a good regulatory regime achieves its objectives. There seems to be nothing in the list of desirable characteristics (except perhaps for the statement that regulatory processes should be “cost-effective”) that suggests that regulation should achieve anything.

Chapter 4: Objectives of economic regulation

Question 1: Do you agree that a regulatory regime needs to be available to address issues in markets with monopoly characteristics?

Yes. Governments should act decisively to resolve enduring market failures where government action generates better outcomes than inaction. A regulatory regime that defines clear rules for government action is very important for investors in long-lived assets in areas that are, or could be, subject to regulation.

Question 2: Do you consider that the sole or primary objective of a regulatory regime should be economic efficiency or consumer protection (distribution), or do you consider that both should be taken into account?

The Telecommunications Act test needs clarifying as well

Arrangements under the Telecommunications Act seem to have settled somewhere between the two middle options in the table on page 25. The Commission states that consumer welfare is the standard, but always calculates both total welfare and consumer welfare figures in its cost benefit assessments.

There is strong disagreement between the industry and the Commission on which approach is legally correct. We requested that the Ministry clarify the situation in the recent amendments to the Telecommunications Act. No such amendments were made.

We have sought clarity elsewhere. We filed a judicial review against the Commission’s first final report on the regulation of mobile termination rates in June 2005. One of the grounds for review was that the Commission’s preference for the consumer welfare test was legally mistaken. This review application was withdrawn when the Minister sent the report back to the Commission in August 2005.

At this stage we conclude that the test for intervention under the Telecommunications Act is unsettled. We are not aware of a case where the Commission’s commitment to the consumer welfare test has been really tested, i.e., one where total welfare numbers were negative but consumer welfare positive.

Using only the consumer welfare standard would be perilous

We note the Commission’s comments that using the total welfare standard will mean that regulation is very hard to justify. Presumably this is why its approach in telecommunications has been to favour the consumer welfare test. But the corollary to

the Commission's statement is also true: using the consumer surplus standard will mean that regulation is always much easier to justify.

We would not want to see a situation where the Commission can justify regulatory action on any service just by showing that New Zealand prices are above some international benchmark. In these circumstances:

- Transfers from producers to consumers could well be decisive, since even if the price difference on the service is small, the volume could be large.
- Allocative efficiency gains will be small, and the costs of regulation are unlikely to matter, since both will be dwarfed by the scale of the supposed excessive pricing by firms.

The appropriate test depends on the circumstances

The proposal in the paper to take both consumer welfare and total welfare into account seems very sensible to us. We approve of the Commission's approach in calculating both sets of figures. We only part company with the Commission to the extent that it emphasises consumer welfare over the total welfare test in circumstances where it is not clear that pricing is excessive nor that alternative entry is infeasible.

We would argue that, at least in sectors characterised by a high level of technological change, preference should be given to the total welfare test rather than the consumer welfare test. It is only the presence of rents that encourages competitors to enter the market or change their market behaviour to secure those rents for themselves. Put another way, the presence of rents can not be in itself an argument for regulation in any case where the market is contestable. If all prices are reduced by regulatory action to some estimate of cost, then competition in the dynamic sense will not be able to work.

Another way of thinking about this is the question of whether rents have an economic function. In the case of economically functionless rents (like over-charging by a natural monopoly), counting transfers as a benefit would seem appropriate: they generate value for consumers and have no impact on the regulated firm. But in cases where economic rents are useful to encourage competitors (in situations where competition is actually possible), a total welfare test would be a better guide to regulatory decision-making.

Such an approach also focuses attention on empirical issues, like establishing whether the market is contestable or determining whether competitive entry is likely during the regulatory period and affected by the regulatory change. This is a more productive debate than the ongoing legal arguments that have characterised the question of which test should be used under the Telecommunications Act.

Investment effects are important

We also have just one comment to make about regulation and investment. This is not an answer to any particular question but it is relevant to the issues discussed in the section on regulatory objectives.

The paper suggests, quite rightly, that the connection between regulation and incentives for investment is important. If regulation curtails the returns that investors expected from some costly innovation there would certainly be a chilling effect on investment. Even worse, there could be negative effects on long-term investment as a result of mere uncertainty about what the rules covering such an investment might be.

The paper does not, however, refer to a related investment problem, which is what happens if the regulator declines to regulate on the basis that regulating would reduce investment but then that investment does not actually happen.

We may have seen just such a situation in telecommunications regulation. The Commission declined both to mandate local loop unbundling and limited the upstream speed of regulated wholesale internet services to 128kbps (a limit that still prevails for most consumers in the market) because of fears that any more aggressive regulation would limit Telecom's incentive to invest in its network. In practice, the investments that were said to be at risk in 2003 still do not appear to have happened (although they seem to be now being planned).

The point is that under conditions of monopoly higher prices in themselves may not be sufficient to encourage investment. Although it is easy for a monopolist to argue that without higher prices it will be deterred from investing, in fact the firm may simply accept higher prices for services delivered over existing assets and not invest. This is, after all, what we expect a priori from an unconstrained monopolist—underinvestment combined with pocketing rents. Therefore in these circumstances some kind of constraint is necessary, such as a link between regulatory forbearance and investment, or clearer quality standards for regulated services. This might be a useful tool to prevent overly theoretical debates about supposed chilling effects on investment from regulation.

Chapter 6: The decision on whether to impose regulation

Question 1: Do you agree with the proposed criteria for deciding on whether regulation should be imposed?

In line with our comments above about the objectives of economic regulation, we suggest a test that gives much clearer guidance on when the consumer welfare test or the total welfare test should be used.

If Option A amongst the competition criterion is to be preferred, we would suggest that “in a reasonable timeframe” or similar words be inserted to qualify the “prospect of competition”.

Question 3: If you agree that one of the tests for whether control may be imposed should be where the long term benefits to acquirers exceed direct and indirect costs, should those benefits be considered regardless of whether acquirers acquire the goods and services *directly or indirectly*, or should it be necessary to establish that benefits *will* be passed on to end users (or consumers or end-acquirers)?

In our view passthrough of benefits to final end users is critically important. If there is no passthrough, then regulation can simply end up generating transfers from one set of producers to another while counting them as a benefit from regulation. Regulation then becomes a pointless money go round that generates no meaningful change in

behaviour. Worse, in industries with relatively few firms, regulation that shifts wealth between them can end up distorting the competitive playing field.

This was a very important issue in the mobile termination rate investigation, with the Commission (appropriately in our view) only counting as benefits price reductions that ended up in the hands of consumers.

Question 6: Do you agree that the Minister should remain the decision-maker on whether control should be imposed under Part 4, but that the Minister must receive a report and recommendation from the Commerce Commission before making a decision?

This approach seems like a sensible balance between the specialist role of the regulator and the political accountability of the Minister.

Other approaches are possible. For example, in our submissions on the telecommunications stocktake we suggested giving the Commission more authority and making it more independent, but replacing the Ministerial signoff of Commission's decisions with a merits review option for regulated firms.

Chapter 7: Types of economic regulation

Question 1: Do you agree that it is desirable to widen the scope of the Commerce Act by providing for regulatory options other than control?

This certainly seems like a useful idea. The 2002 European regulatory framework for telecommunications, for example, allows regulators to choose options from a generic list of remedies that includes obligations of access, non-discrimination, transparency, accounting separation and price control. Structural and operational separation have been proposed as additional remedies in a review of the framework that is going on at present.

Question 2: Do you consider that specific, easier tests should be provided to determine whether lighter-handed types of regulation, such as information disclosure, may be imposed?

It seems unnecessarily complicated to create special legislative tests just to enable the imposition of relatively unobtrusive regulatory obligations. Equally it seems unduly costly and difficult to require the Commission to embark on an extensive quantitative cost benefit assessment to decide whether or not to impose information disclosure obligations.

One simple approach would be to leave a single test in legislation, but to encourage the Commission to adapt the extent of its analysis to the nature of the problem at hand. That is, the less extensive the regulatory control proposed, the less extensive its regulatory analysis would need to be.

Chapter 12: Accountability mechanisms

Question 1: Do you consider that it is desirable to provide for merits review of regulatory decisions or does judicial review provide sufficient constraints on regulatory decisions?

Vodafone considers it highly desirable that regulatory decisions are subject to merits review. A good merits review process diminishes the likelihood of regulatory error. This provides for a more transparent regulatory landscape which increases confidence in the regulatory process and promotes long term investment decisions.

Merits review processes are a feature of regulatory decision-making in comparable jurisdictions including Australia, the United States and the European Union. They are viewed internationally as an essential part of regulatory best practice.

While judicial reviews can help to ensure the processes are followed correctly, the aim of a merits review process is to ensure that a quality decision has been made. The current approach of having only judicial review available to regulated businesses creates perverse incentive for the Commission to prioritise process over the substance of a decision. Sound process and the substance of decisions are both important complementary aspects but one should not be prioritised above the other.

The discussion document raises in paragraph 222 the arguments against merits reviews. It is worthwhile addressing these issues briefly:

- Additional costs of litigation for both the Commission and the business - Costs to the Commission can be mitigated by awarding costs against unsuccessful appellants. In addition, it is important to bear in mind the scale of the issues relative to the costs of the process. For example, mobile termination rate regulation as proposed by the Commission would have meant a loss of \$250 million in wholesale revenue to Vodafone. In the context of such a massive loss, additional costs in checking that the decision is the correct one pale into insignificance.
- Additional funding for the Commission to ensure they 'get it absolutely right' in the first instance - Given the power of the Commission and the potential costs to investors of poor decision-making the Commission should always be funded to a level where it has the resources to be confident in its decisions.
- Delays to regulatory processes – Decisions should take effect notwithstanding a merits review so the implementation of decisions should not be delayed. In addition, further discipline imposed on the Commission has the potential to improve decisions which can reduce the requirement for appeals and lead to faster more effective decision-making.
- Potential for simply different (rather than better) outcomes, as different experts may come to different conclusions. - Certainly there is a need to avoid pointless relitigation. But we would expect an appeal body to be aware of this risk and to carefully consider whether it is appropriate to substitute its decision for that of the Commission in the circumstances of the case.
- Incentives for regulated businesses to 'game' the system in search for the ultimate decision-maker – In a regime where the decision takes effect notwithstanding an appeal and costs are awarded against unsuccessful

appellants it is difficult to see what would be gained by a merits review process if the appellant did not have a reasonable degree of confidence that the Commission had made an error.

It has not been the experience of regulatory regimes overseas that merits reviews processes have led to frequent appeals and 'gaming'. For example, while in Australia's Gas Access Regime there have been in excess of thirty access arrangement decisions on gas transmission and distribution, there have been only four applications for merits review.¹

Paragraph 223 of the discussion document also notes that 'while merits review may improve quality and confidence in the regulatory decision-making, this may come at a substantial cost.' It is worth noting that if an in-depth assessment of the costs is to be made those costs must be balanced against the benefits for the New Zealand economy of having world's best practice regulatory regimes as this increases transparency and promotes the confidence required for investment decisions.

More generally on this point, the costs of merits review do not seem high relative to either the costs and benefits of regulation, or the costs of the current process.

Investment in key infrastructure is an important part of increasing New Zealand's productivity and its sustainable growth rate. Vodafone's view is that the establishment of merits review process will support this much needed investment.

We have attached a brief article on the subject of merits review in telecommunications that might help to illustrate our concerns with the existing framework.

Question 2: Do you agree with the document's conclusions that, if merits review is provided for it should only apply to control decisions made by the Commission and be limited to the form of 'appeals by way of re-hearing' where new evidence can be introduced only if it is fresh and material and it could not have been submitted at the original decision-making stage?

We do not wish to comment at length on which types of decisions should be subject to review, this is more appropriately done by those parties directly affected by Parts 4, 4A and 5 of the Commerce Act. We look forward to more detailed discussion on this should the Ministry follow the Finance and Expenditure Committee's suggestion and consider the merits review issue in the context of the Telecommunications Act following the current piece of work.

That said, we would certainly question the efficacy of a system that did not allow merits review of final recommendations from the Commission on whether to impose control. In our experience in telecommunications (where the equivalent decisions are whether to specify or designate a telecommunications service) these are the most fundamental of the Commission's reviews of an issue. The determinations that follow in relation to a service take as given the basic approach established in the decisions to impose control.

¹ Ministerial Council on Energy Standing Committee of Officials, *Review of Decision-Making in the Gas and Electricity Regulatory Frameworks*, Discussion Paper, 10 October 2005, p6.

These recommendations are, of course, considered by the Minister and as the paper points out, the Minister is subject to a wider form of accountability. However, this accountability makes it highly unlikely that the Minister will correct the Commission on analytical points or even consider the quality or reasonableness of the Commission's (usually extensive) work on the issue. Our experience has been that the Ministry has limited interest in arguments about the technical aspects of the Commission's work. In addition, regulated firms have limited rights in the Ministerial decision-making process. There are few, if any, legislative requirements for the Minister to follow. For example, s/he is under no obligation to consult with the regulated firms or to consider their arguments in the course of making his decision.

In our view these factors make Ministerial decision-making alone inadequate as compared with merits review as a review mechanism for Commission decisions.

We support holding merits reviews by way of rehearing. This approach places an incentive on parties to produce the best possible evidence and analysis during earlier stages of the process while retaining flexibility should new evidence become available. It will minimise the costs of the review process and ensure parties focus early on the key issues.

Question 3: What is your preferred composition of any merits review body, taking into account New Zealand's small size and limited resources?

We note that overseas appeals are commonly heard by specialist appeals bodies such as the Australian Competition Tribunal and the Competition Appeals Tribunal in the United Kingdom. A permanent body would be an option in New Zealand to ensure consistency and allow for the development of expertise, but it seems very costly relative to the number of cases that it would actually hear, and it may not be practical given New Zealand's limited pool of resource.

Our preference is to continue with the High Court sitting with a lay expert, in line with the current approach under authorisation and clearance provisions of the Commerce Act.

Thank you for the opportunity to submit on these important issues. Please do not hesitate to contact me if you wish to discuss any of the above on 021 811 999 or at julian.kersey@vodafone.com.

Yours sincerely

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