

## **Litigation Versus Regulation: How Successful Is Light-Handed Regulation?**

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### **I: INTRODUCTION**

The establishment, implementation and monitoring of legislative frameworks for the fair and efficient conduct of business and the operation of markets... rewards innovation, promotes efficiency and enhances investor confidence.<sup>1</sup>

This statement encapsulates the change in public ideology that ultimately led to the deregulation, corporatisation and privatisation of many of our public utilities in the pursuit of efficiency. Historically, economists and the public alike believed it was the government's duty to provide certain essential services such as telecommunications, electricity, gas, and postal services. This was due to the assumption that these services were supposed to be provided at low or no cost so no private firm could operate profitably in these industries. Thus it fell to the government to provide these services as part of our nation's infrastructure. This ideology changed in the 1980s when prominent economists led the government and the people to believe that these organisations could perform more efficiently if they were corporations with the same objectives as private companies. During this decade the New Zealand economy underwent radical economic changes, with almost all aspects of economic policy being overhauled. One of these aspects was the transition of former government departments into corporations and later the privatisation of these corporations.

Many of these former government departments were natural monopolies, a term which connotes an industry where one firm can offer the service at a lower cost than two or more firms, due to the infrastructure involved. For example, in the electricity industry it is not economically efficient to replicate the lines throughout the country. This is a significant barrier to entry, and hinders competition. This led many other countries to foster competition through regulation. New Zealand, however, chose complete deregulation and believed light-handed regulation through the Commerce Act 1986 and information disclosure regulations would be sufficient to promote

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<sup>1</sup> Statement of the Government's Strategic Result Areas.

competition. The New Zealand government maintained that competition and regulation are ideological opposites and that the best way to ensure efficiency is through competition, not regulation. But has deregulation achieved its goals?

I will attempt to answer this question based on the experience in New Zealand to date, with particular regard to the telecommunications and electricity industries. First, I will outline the mechanisms implemented in Australia, the United Kingdom and the United States to regulate these natural monopolies; then I will analyse the New Zealand situation, and describe the transition from a heavily regulated to a competitive industry. An analysis of the Commerce Act 1986, New Zealand's main competition legislation which is relied upon by the government to monitor the newly deregulated industries, follows. Finally, I shall canvass opinion as to the effectiveness and efficiency of the regulatory changes in New Zealand. I conclude with a discussion of suggested reforms.

## II: REGULATION IN VARIOUS JURISDICTIONS

### 1. Australia

#### *(a) Telecommunications*

The Australian experience in telecommunications illustrates a gradual shift towards competition. In 1975 the Australian Telecommunications Commission was established, subsequently becoming a corporation ("Telecom") in 1989 under the Australian Telecommunications Corporation Act 1989. The national satellite system was delegated to Aussat Pty Limited ("Aussat") in 1981.<sup>2</sup>

Despite an initial inquiry in 1981, little was done to restructure the telecommunications industry until 1988 when a further review was undertaken. The resulting Telecommunications Act 1989 was the first major shift in policy towards competition. This statute continued the authority of the then existing carriers, Telecom, the Overseas Telecommunications Commission ("OTC"), and Aussat, to be the sole providers of basic telecommunications network facilities and services, but subjected them to more regulatory intervention, particularly by the newly created Australian Telecommunications Authority ("Austel").

The opening up of the telecommunications industry to competition was further enhanced by the Telecommunications Act 1991 ("Telecom Act"). A basic duopoly over the provision of general carriage was created by the merger of Telecom and OTC into the Australian and Overseas Telecommunications Corporation (now Telstra Corporation Limited ("Telstra")), and the privatisation of Aussat (now Optus Network Pty Limited ("Optus")). In addition, the Telecom Act established three mobile carriers:

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<sup>2</sup> Under the Satellite Communications Act 1984, Aussat was owned 25 percent by Telecom, and 75 percent was held in trust for the Federal Government. Aussat was prevented from providing domestic public switched telephone or data services.

Telstra, Optus and Vodafone. Subject to some general price and tariff rules, the carriers were free to exploit the economies of scale and scope available as a result of their control of telecommunications facilities. The industry has been further deregulated by the Telecommunications Act 1997.

The philosophy of the government in bringing about these changes was that the creation of one strong competitor was the best way to achieve genuine and sustainable network competition quickly.<sup>3</sup> A specific access regime for essential services was introduced into the Trade Practices Act 1974 (“TPA”) in 1996. In sum, Australia relies on several regulatory measures: an industry-specific regulator, Austel; industry-specific competition provisions within Part XIB of the TPA; general competition laws contained in Part IV of the TPA. Nevertheless, Australia has not avoided competition disputes. On 13 April 1999, the Australian Competition and Consumer Commission (“ACCC”) issued a fourth competition notice against Telstra in respect of its failure to implement an efficient and effective local call transfer process, called the “commercial churn”. The ACCC believes that the costs of the commercial churn transfer process that Telstra provides to its competitors in respect of local calls remains too high.

The Hilmer Report, prepared in 1993,<sup>4</sup> sparked major reforms to national competition policy and suggested that adequate control of anti-competitive conduct in telecommunications could and should be achieved within the framework of national competition policy.<sup>5</sup> The Hilmer Committee stated that there should be no regulatory restrictions on competition unless clearly demonstrated to be in the public interest.<sup>6</sup> Whether or not Australia will follow New Zealand down this route is unsettled as yet.

### (b) *Electricity*

The changes underway in the Australian electricity industry are surpassed only by those being seen in telecommunications. The State of Victoria has paved the way for a national reform process in their reform of the electricity industry. The electricity industry in that state has been split into separate generation, distribution and retail businesses, and a system operating business. Many businesses have been privatised, often purchased by American interests.<sup>7</sup> There is fierce competition among distributors, ensuring the lowering of prices, although the industry is still overseen by the independent Office of the Regulator General (“ORG”), the Victorian regulator. Domestic consumers will be able to choose their supplier from January 2001.<sup>8</sup>

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<sup>3</sup> Peters, “From One Horse Race to Competition: the Telecommunications Marathon. Will the Winners Step Up to the Podium Please?” (1994) 17(1) UNSWLJ 190.

<sup>4</sup> National Competition Policy: Report by the Independent Committee of Inquiry, AGPS (1993).

<sup>5</sup> The package comprised the Competition Policy Reform Act 1995, a Competition Code Agreement, a Competition Principles Agreement and an agreement of financial arrangements.

<sup>6</sup> Taperell, “Competitive Conduct Rules for Telecommunications after 1997: Will National Competition Law Suffice?” (1995) 3 Competition and Consumer Law Journal 165.

<sup>7</sup> Moran, “The ‘R’ Files: Electrifying Changes On-Line” (1997) 49(3) Ipa Review 32.

<sup>8</sup> Hazan, “Industry Transformation is Under Way Worldwide” (1997) 49(5) Transmission & Distribution 45.

New South Wales (“NSW”) has announced a timetable for opening up its market, which it plans to complete earlier than Victoria did. The NSW reforms have, however, created two very large distribution companies and left a duopoly in the generation business. Other states, such as Tasmania, Northern Territory and Western Australia, have barely begun reforms, since these states are far removed from the rest of the country, so connecting with the electricity pool would be extremely expensive.

A national market is planned, and was to begin in early 1998, but this has been delayed due to the complexity of the reform. Instead, a decision was made to develop the harmonised National Electricity Market 1 (“NEM 1”), managed independently by the National Electricity Market Management Corporation. This included NSW, Victoria and the Australian Capital Territory (“ACT”) initially, with South Australia joining later. Queensland is due to join the national market in 2001 when a transmission interconnector is completed. Tasmania may join when a high voltage direct current cable to Victoria is installed, possibly within four years. Geographical considerations preclude the inclusion of Western Australia and the Northern Territories from the National Market.<sup>9</sup>

The industry is regulated by the National Electricity Code,<sup>10</sup> which includes the terms of an access undertaking that sets out principles for the determination of network service pricing to be applied by regulators. Each State must enact complementary legislation giving force to this Code. The Code must be accepted by the regulator, the ACCC. Non-compliance that breaches the Code may also breach the TPA.<sup>11</sup>

## 2. United Kingdom

### (a) Telecommunications

The British Telecommunications Act 1981 (“British Telecom Act”) terminated British Telecom’s monopoly over customer premises equipment and supply of services, except for the initial telephone, which had their monopoly terminated in 1985. The first entrant into the market was Mercury, which received a 25 year renewable licence to operate in February 1982. In 1983, the government announced a new duopoly policy, blocking the entry of new suppliers of public, fixed-link voice telephony for seven years. The government’s intention was to effect a gradual transition to competition so that the new firms, Mercury and the soon-to-be-privatised BT,<sup>12</sup> could establish themselves before facing the threat of full competition. By the time the duopoly policy expired, Mercury had become a viable competitor. However, greater

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<sup>9</sup> George, “Privatisation ‘Genie’ is Out of the Bottle” (1998) 50(4) *Transmission & Distribution* 32.

<sup>10</sup> King, “Efficiency and Access: Analysing the Draft Access Code for Australian Electricity Transmission” (1996) 29(2) *Australian Economic Review* 292.

<sup>11</sup> Dunn & Rossi, “Practical Aspects of Electricity Restructuring” (1996) 9(8) *Electricity Journal* 44.

<sup>12</sup> British Telecom was privatised by the Telecommunications Act 1984.

competition was allowed in peripheral services such as cellular networks, transmission of computer data and supply of equipment.

The innovations were taken further with the Telecommunications Act 1984 which established the regulatory regime by: creating OfTel, the national regulator of the telecommunications industry; requiring licenses for all private telecommunications operators; bringing the Monopolies and Mergers Commission into the regulation of licensees. The United Kingdom has adopted a hybrid system of telecommunications regulation by using industry-specific legislation combined with general competition law principles which are tailored to accommodate the dynamics of the industry. There are three main ways in which competition is controlled. First, the regulator, OfTel, is very active in the industry. OfTel is responsible for policies concerning licensing and equipment approval. Second, major industry participants are subject to "fair trading" licence conditions. Third, telecommunications competition is regulated by the general competition rules controlled by the Monopolies and Mergers Commission.<sup>13</sup>

*(b) Electricity*

In 1983, the government attempted to inject private competition into the electricity industry by allowing private generation and supply, and by allowing third party access to the national transmission grid and the local distribution systems under the Energy Act 1983. By 1990, however, only one company had taken advantage of the opportunity to take a bulk supply of electricity from something other than a public corporation. This public system changed from 31 March 1990, when the Electricity Act 1989 ("Electricity Act") came into force. The new structure for the industry is similar to the structure in the telecommunications industry, with licences being issued to private competitors. The Act also split the industry into separate generation, lines, and distribution companies.

All generators, suppliers and transmitters of electricity must be licensed. It is these licences and private contracts that contain the regulations and rules as to the commercial operation of the privatised system. The licenses provide for price regulation and are monitored by Offer, the Office of Electricity Regulation, which has primary responsibility for the regulatory and licensing regime and price regulation system established by the Electricity Act. The Monopolies and Mergers Commission also has a part in the regulation of the industry, playing an essential role in the licensing regime. The power of Offer was extended in the Competition and Service (Utilities) Act 1992, which intended to bring the regulation of all utilities into line and used the electricity regulations as the ideal.

When the electricity companies were privatised, the government retained a "golden share" in each of the successor companies of the original public companies. This golden share ensures the maximum of fifteen percent shareholding, and prevents undesirable takeovers. The golden share can be seen as providing the government

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<sup>13</sup> Hardy, McAuslan & Madden, "Competition Policy and Communications Convergence" (1994) 17(1) UNSWLJ 156.

with a useful instrument to control the ownership characteristics of the future privatised electricity supply companies. This is similar to the Kiwi Share that the New Zealand government retained in New Zealand's Telecom, in that it protects and promotes the government's interest in the electricity companies while retaining a non-interventionist stance.

### **3. United States**

#### *(a) Telecommunications*

The state of telecommunications in America is notorious, primarily due to the break-up of the giant AT&T in the 1982 Consent Decree, which was intended to subject the industry to more competition. Since 1934, Congress has passed legislation creating a specialised system of regulation, though regulation did exist prior to this in other less specific ways. The Communications Act 1934 ("Communications Act") transferred telephone regulation from the Interstate Commerce Commission to the Federal Communications Commission ("FCC"). A dual regulatory system between State and Federal regulators remained in effect until the Telecommunications Act 1996 ("Telecom Act").

In 1982 the Federal Government and AT&T entered into a consent decree in which AT&T divested itself of its Regional Bell Operating Companies. A new regulatory scheme developed in which the long-distance market was open to competition, while local markets continued to operate under natural monopoly regulations. As competition evolved in the long-distance market, Congress perceived that the Communications Act was no longer geared to address this new market effectively. The Telecom Act does not replace the Communications Act, but merely modifies and supplements it. In the short term, FCC and regulatory intervention is limited to the more focused task of kick-starting new market entrants.

Substantial deregulation is clearly the long term goal of the Telecom Act. Its main problem is that it fails to delineate a clear shift from a status quo of regulation to a default condition of deregulation with pockets of regulatory intervention only when necessary.<sup>14</sup> There are two mechanisms in the Telecom Act for phasing out regulatory control. First, discretionary forbearance, whereby the FCC must forbear from applying a statutory provision or regulation if the FCC determines that the regulation is no longer needed. Second, mandatory FCC regulatory review, under which the FCC must perform a biennial review of each FCC regulation issued under the Telecom Act and must repeal or modify any regulation no longer in the public interest. It is arguable whether or not the Telecom Act will be successful in ensuring the transition to deregulation since there is no restriction on the FCC issuing new regulations.<sup>15</sup> In

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<sup>14</sup> Bruning, "The Telecommunications Act of 1996: The Challenge of Competition" (1997) 30 *Creighton Law Review* 1255.

<sup>15</sup> Nowicki, "Competition in the Local Telecommunications Market: Legislate or Litigate?" (1996) 9(2) *Harvard Journal of Law and Technology* 353.

the long term, as even the FCC has agreed,<sup>16</sup> full deregulation is needed to ensure full, unrestricted, efficient competition. In the short term, Congress has decided that the FCC should guide the telecommunications industry towards substantial deregulation.

*(b) Electricity*

The electricity industry in the US has been dominated for over seventy years by for-profit vertically integrated utilities that combine generation, transmission and distribution assets within the same corporate structure and provide power to a monopoly franchise service territory. In return for these monopoly rights utilities are subject to both federal and state regulation.<sup>17</sup> Despite the fact that most of the electricity that was generated and transmitted was produced by privately owned systems, the industry was still subject to considerable regulation. On a general level, federal authorities were responsible for regulation of activities among utilities while state authorities oversaw activities of utilities relating to ultimate customers.<sup>18</sup>

The failure of regulation to adequately police the electricity industry led to growing dissatisfaction amongst the public and a call for change. The legal change began with the Public Utilities Regulatory Policies Act of 1978, which required utilities to buy power from co-generators and small power producers at a price based on the utility's avoided cost. While this Act was initially less than successful, it did foster the rapid growth of an independent power production industry.

In the Energy Policy Act 1992 ("Energy Act") Congress eliminated the size and technology limits on independent generating units that can make unregulated sales under the Regulatory Policies Act. Further, the Energy Act also amended the Federal Power Act to permit the Federal Energy Regulatory Commission ("FERC") to compel utilities that own transmission lines to provide power transmission to wholesale power producers. This encouraged competition in the wholesale power market and caused a substantial growth in the number of electricity generating companies. The independent power sector of the industry is now structurally competitive, with over fifty major firms and many more small firms bidding to meet demand for power. The competitive bidding process has led to a substantial decrease in the price of wholesale power. Nevertheless, regulators are still active in helping to set pricing, and support the development of regional power transmission companies.<sup>19</sup>

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<sup>16</sup> Hall, "The FCC and the Telecom Act of 1996: Necessary Steps to Achieve Substantial Deregulation" (1998) 11(3) *Harvard Journal of Law and Technology* 797.

<sup>17</sup> Pace & Landon, "Introducing Competition into the Electric Utility Industry: An Economic Appraisal" (1981) 3(1) *Energy Law Journal* 1.

<sup>18</sup> *Ibid.*

<sup>19</sup> Blank, Gilliam & Wellinghoff, "Breaking Up is Not So Hard to Do: A Disaggregation Proposal" (1996) 9(4) *Electricity Journal* 46.

#### 4. New Zealand

##### (a) Telecommunications

The New Zealand telecommunications industry has changed profoundly in the last twelve years. While new technologies such as digital switching, fibre optics and cellular telephony have had an impact on the industry's structure and services, the introduction of competition has been the sharpest change to the industry itself. The resulting impressive productivity performance of the industry has sustained large price and service improvements, flowing through into large welfare gains. Competition disputes have occurred, due to the government's innovative "light-handed" regulatory stance. The government has pursued a quiet background role, forming regulations,<sup>20</sup> and advisory groups,<sup>21</sup> where necessary, as well as threatening major legislation changes if the main players cannot agree amongst themselves. New Zealand now has one of the most liberal regimes in the world for control of public utilities, which is in stark contrast to its previous position as one of the most regulated nations in the western world.

The Telecom Corporation of New Zealand Limited ("Telecom") was restructured into a state-owned enterprise on 31 March 1987 pursuant to the State-Owned Enterprises Act 1986 ("SOE Act") and was intended to operate as a commercial enterprise and to return profits to the government. The SOE Act also imposed social responsibilities on Telecom, as with every other state-owned enterprise.<sup>22</sup> Due to corporatisation and the subsequent restructuring, Telecom's efficiency improved considerably,<sup>23</sup> and the government was earning respectable profits from the operation of Telecom when the decision to privatise was made. Telecom was sold to an international consortium on 12 September 1990.<sup>24</sup>

Since 1987 the government has progressively removed the statutory controls that prevented parties other than Telecom from entering the telecommunications market. In April 1989 the final statutory barriers to market entry were removed. Government statements have emphasised the aim of maintaining an efficient telecommunications industry.<sup>25</sup> Competition exposed Telecom to strong incentives to improve its performance, while corporatisation and privatisation removed some of the constraints on its doing so. Emerging technologies greatly facilitated efficiency improvements. The government expected that if sufficient competition could be achieved, an industry-specific regulator could be avoided. Residual competition disputes invoking the Commerce Act 1986 ("Commerce Act") would then be resolved

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<sup>20</sup> For example the Telecommunications (Disclosure) Regulations 1990.

<sup>21</sup> For example the Telecommunications Numbering Advisory Group.

<sup>22</sup> State Owned Enterprises Act 1986, s 4.

<sup>23</sup> Duncan & Bollard, *Corporatisation and Privatisation, Lessons from New Zealand* (1992).

<sup>24</sup> The consortium included two major American telecommunications operators, American Information Technologies Corporation and Bell Atlantic Holdings Ltd. The other members of the consortium were Fay Richwhite Holdings Ltd and Freightways Holdings Ltd.

<sup>25</sup> Williamson, "Government Statement on Competition in Telecommunications Markets" Minister of Communications' Office (1991).



in the courts. In the absence of sufficient competition, the price control provisions of Part IV of the Commerce Act could be invoked as a last resort. This regulatory approach is known as “light-handed regulation”.

Nevertheless, it has not been a complete change from monopoly to competition: a number of regulatory instruments have been put in place.<sup>26</sup> The industry is governed by the Telecommunications Act 1987, which provides for the recognition of new entrants and allows regulations to be made requiring Telecom and its operating companies to publish financial statements, prices and terms and conditions on all products and services (including interconnections) so that the public can monitor its performance. The Telecommunications (Disclosure) Regulations 1990 (“Disclosure Regulations”) attempt to remedy the problem of Telecom’s market power causing it to have significantly more market-place information than that available to potential competitors and consumers. The Disclosure Regulations have recently been reviewed and significant changes have been suggested.

In addition to these specific statutory mechanisms, the telecommunications industry is subject to the general provisions of the Commerce Act 1986 and the Fair Trading Act 1986, New Zealand’s general competition laws. A number of less formal regulatory measures also exist. These include: statements of government policy; promotion of the New Zealand Telecommunications Numbering Advisory Group forum to seek agreement on telecommunications numbering issues between carriers, users and government; the publication of service quality indicators by Telecom at the behest of the Minister of Consumer Affairs; joint briefings of officials by parties to interconnection disputes to elucidate the issues in dispute; direct intervention by Ministers to urge a particular course of action.

In order to protect the public service element of telecommunications, the government negotiated a Kiwi Share, which was incorporated into Telecom’s Articles of Association when Telecom was corporatised. This represents New Zealand’s approach to a universal service obligation. Pursuant to this Kiwi Share, Telecom undertook to provide an option of local free calling available to all residential customers, with a line rental charge which will not rise faster than the rise in the cost of living unless Telecom’s regional operating company profits are unreasonably affected. Furthermore, the Kiwi Share provides that line rental charges for residential customers in rural areas will not be higher than in cities, and residential service will remain widely available.

Significant problems with the Kiwi Share have been identified. The constraints introduce significant welfare losses by distorting prices and inhibiting the development of efficient competition by making subsidised residential service unattractive to entry. It complicates the negotiation of interconnection, since it is unclear whether firms wanting interconnection should be made to contribute to the cost of the Kiwi Share.<sup>27</sup> Inflating prices for business users and toll calls to cover the cost of the residential rental encourages inefficient entry in these markets and inhibits competition in the

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<sup>26</sup> Janisch, “From Monopoly Towards Competition: What Role for Competition Law?” (1994) 23 *Canadian Business Law Journal* 239.

<sup>27</sup> *Ibid.*

residential local market. Moreover, if competitors in the toll and business markets are forced to make a contribution to the cost of a residential cross-subsidy, they may be encouraged to bypass established networks, which may lead to an inefficient duplication of resources.<sup>28</sup>

In the national and international long-distance service markets there has been healthy competition, particularly since 1996. In addition to Clear and Telstra, Global One, WorldxChange and Telegroup have increased their profiles, offering cheaper rates than either Clear or Telecom. Despite the fact that toll call prices have tumbled since deregulation, largely due to the competition Telecom has experienced with Clear Communications Limited ("Clear"), the cost of having a phone has risen each year since 1990 by the cost of inflation, the maximum price rise Telecom is permitted.<sup>29</sup> On the other hand, product offerings have grown rapidly, driven primarily by the emergence of new technologies. Business customers have benefited the most from the deregulation of the industry.

While there are no statutory barriers to entry in the telecommunications market, there are still substantial economic barriers. Telecom has significant first-comer advantages, and the local loop is still arguably a natural monopoly to which a competitor must have access before they can hope to compete effectively with Telecom. Despite Telecom's formal "commitment" in June 1988 to fair and reasonable interconnection on the basis of cost, interconnection has been the basis of much litigation.<sup>30</sup> Telecom still owns the numbering system, and controls the equipment and network standards. Telecom has both the opportunity and incentive to deny access by potential competitors to its network because it is vertically integrated. It is both a monopolist in the market for sale of rights to the network and a competitor in the downstream markets for telephone services.

From the viewpoint of competitors, the market is still far from fully contestable. Clear was the first competitor to enter the market, and since May 1991 Clear has offered private network services, national call services and outgoing international call services. Clear is seeking to enter the local call market, but is as yet unable to reach an agreement regarding interconnection with Telecom. Indeed, the relationship between Telecom and Clear has been characterised by frequent interconnection disputes, often resulting in litigation.

BellSouth (NZ) Limited ("BellSouth") also attempted to enter the telecommunications market in New Zealand, and while it was successful in entering the cellular communications market, it has recently left New Zealand,<sup>31</sup> selling its cellular business to Vodafone, a British firm, and foregoing its intention to enter the fixed communications market. Telstra, the Australian telecommunications firm, has also announced plans to enter the New Zealand local and cellular markets, though it

<sup>28</sup> Flood, "Regulation of Telecommunications in New Zealand - Faith in Competition Law and the Kiwi Share" (1995) 3 Competition and Consumer Law Journal 199.

<sup>29</sup> Love, "Battling it Out in Telecommunications" *The Evening Post* 5 Aug 1998, 16.

<sup>30</sup> Telecom and Clear alone have had 6 separate disputes over interconnection, though not all of these have led to court.

<sup>31</sup> BellSouth announced its intention to leave the New Zealand telecommunications market on 26 August 1998.

is less than competitive as yet. Saturn Communications Limited, another small competitor, entered the market for local calls, offering a limited service to residents of Lower Hutt and Kapiti only. Despite the limited entry of Saturn, it managed to raise Telecom's ire. Telecom responded vigorously by offering low rental to those living in Lower Hutt and Kapiti.

The lack of competition in the residential local market, coupled with the protracted and socially expensive litigation, can be attributed to the lack of foresight by the government in 1987 upon corporatisation. Instead of transferring all the telecommunications assets to Telecom, the government should have restructured, separating the contestable and the non-contestable aspects of the market. In the late 1980s the government considered splitting Telecom's services along various lines, but did not do so because of the risk of losing economies of scope. It appears that the government chose cash over competition, since Telecom was obviously more attractive to potential purchasers if it controlled the infrastructure as well as providing a retail service.

### *(b) Electricity*

The electricity industry in New Zealand has not attracted the same level of attention as telecommunications because the deregulation and corporatisation has not promoted entry to the same degree and, as yet, we have not seen the litigation which has characterised the telecommunications industry. This is primarily due to the fact that the government did not undertake the necessary restructuring prior to deregulation, and it has been virtually impossible to enter the retail market. Recent legislation by parliament is intended to remedy this. Construction of hydro-electric dams in the 1970s and 1980s was often driven by job creation motives rather than demand and capacity considerations. In addition to the government-owned generation companies, there were power boards known as Electrical Supply Authorities, and power companies that supplied the customers, each of which had a monopoly on supply in their own areas.

In May 1986, the Government transformed the Electricity Division of the Ministry of Energy into a limited liability company established under the Companies Act 1955. On 1 April 1987 the former Electricity Division of the Ministry of Energy became the Electricity Corporation of New Zealand Limited ("Electricorp"). Just over three years later, the Government decided to split TransPower New Zealand Limited ("TransPower") from Electricorp, with TransPower to be owned by the generators and distributors. The government's objective was to facilitate the development of competitive generation. Electricorp was responsible for the generation and sale of power to retail customers, while TransPower operated the national grid distribution system. On 1 February 1996, Electricorp was split into the Electricity Corporation of New Zealand ("ECNZ") and Contact Energy, to bring greater competition to the management of hydro-electric, thermal and gas-fired stations. The government also intended this split to ignite the wholesale electricity market that began operating in October 1996. The subsequent sale of Contact to private shareholders in May 1999

was eagerly anticipated and over-subscribed.

The Electricity Supply Authorities were corporatised by the Energy Companies Act 1992 and the Electricity Act 1992 and no longer had specific franchise areas in which they could operate unopposed. This has stimulated power struggles, as the dominant players in the market battle for control of the energy companies. This takeover activity has seen the reduction of the number of local electricity supply companies from fifty to thirty-eight. However, it is only since the recent entry of independent corporations such as First Energy and Contact that residents have received the benefits of competition.

After the creation of Electricorp, direct ministerial involvement was limited to negotiation on rates of return targets and dividends. The structure of regulation of the electricity industry is identical to the structure of regulation of the telecommunications industry. The behaviour of the participants in the electricity industry is controlled by the Commerce Act and the Fair Trading Act, again due to the government's policy of light-handed regulation. The Electricity (Information Disclosure) Regulations 1994 are intended to ensure that competitors have all the information they need, and that Electricorp was not unduly advantaged because it owned the infrastructure. The government's philosophy was to make the industry contestable so that firms would compete, bringing prices down and improving service.

The government's aims have not been achieved, largely due to the fact that the local energy companies operate in two businesses, lines (or distribution) and energy retailing. The lines business is a natural monopoly that some companies are exploiting to stifle competition, while others are using the excessive profits from the monopoly to cross-subsidise generation investment. In response, the government introduced the Electricity Industry Reform Act 1998 ("Electricity Reform Act") which was supported by the Commerce Commission, and has proposed further regulatory changes.

The Electricity Reform Act effects the ownership separation of electricity distribution lines from electricity generation and retail activities, mirroring the changes taking place in Australia and England. The explanatory note to the Bill states that the government is aware that line charges and captured customers are being used in several cases to pay for uneconomic power generation, while lower generation costs in other cases are not being passed on to the consumer. The Electricity Reform Act is intended to address the risks of anti-competitive restrictions on access to electricity distribution lines for competing retailers, and cross-subsidisation of electricity generation and retail activities from electricity distribution lines. It is also intended to prevent the integration between competitive and monopoly services, and to amend the Electricity Act 1992 to provide for a regulation-making power which will allow the government to prescribe a mandatory default system to enable consumers to switch between competing electricity retailers.

The Act also effected the split of ECNZ into three State Owned Enterprises, which was intended to stimulate competition and ultimately lead to lower prices. ECNZ, however, estimates that the split will result in a loss between \$900m and \$2,100m of net present value due to increased capital costs, disadvantages of smaller

size and smaller economies of scale and loss of synergies due to loss of portfolio management of hydro and thermal plants. However, some of this loss of value will be due to lower prices. ECNZ also anticipates that the split will reduce the future incentives and opportunities for the new companies to deal with many environmental concerns.<sup>32</sup>

In addition to the split between lines and retail businesses, the government intends to increase the competitive pressures faced by the lines businesses in order to ensure that these businesses become more efficient and pass the benefits of efficiency on to the consumers. The progress of this reform has been halted, however, by opposition in Parliament. The government announced a scheme for imposing price control on the lines companies if they did not increase efficiency adequately.<sup>33</sup> In addition to the Commerce Commission's general power to impose price controls when efficiency requires,<sup>34</sup> there is also to be a specific threshold under which the Commerce Commission can impose price controls on certain businesses that under-perform in comparison with other lines businesses. The Minister for Enterprise and Commerce, Max Bradford, introduced the Commerce (Controlled Goods or Services) Amendment Bill, intended to impose price regulation on electricity lines businesses in particular. The government considered that the threat of price control would mimic competitive market pressures at minimum regulatory cost. This Bill was defeated in Parliament. ACT New Zealand opposed the introduction of such heavy-handed regulation, while others refused to support a Bill that regulated only a part of the market. It remains to be seen whether amended legislation will be introduced. It is therefore unclear how far the government will go in controlling prices, given that price regulation contradicts the ideology of light-handed regulation.

### III. THEORETICAL FOUNDATIONS FOR REMOVING REGULATIONS

The traditional regulatory view in New Zealand reflected concern about the anti-competitive effects of dominant firms, a general distrust of market allocation, and a disbelief in domestic industry's ability to survive under competition. During the past fifteen years there has been a transformation of the way people view economies and the provision of public services. The buzz word has become "efficiency". Consumers have been introduced to the idea that the only way they could be assured of getting low-priced, good quality goods and services is through efficient suppliers, and the only way we could be certain that our suppliers are efficient is if they are subject to competition. The government soon picked up this desire for efficiency and the public began questioning why our public utilities could not also act efficiently.

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<sup>32</sup> (1999) 22(14) TCL 2.

<sup>33</sup> Ministry of Commerce, *Electricity Industry Reform: Discussion Paper on the Operation of Specific Thresholds for Price Control for Electricity Line Businesses* (1998).

<sup>34</sup> Commerce Act 1986, s 53(2).

People began to see that the bureaucratic inefficiencies they had come to expect were no longer acceptable.

The rationale of New Zealand's light-handed approach is that the inefficiencies and cost of regulation by a specialised authority outweigh the benefits; and the unregulated operation of the market, as modified by general competition law, is more efficient in facilitating competition within an industry.<sup>35</sup> The overall objective of this framework was to achieve efficiency, the assumption being that clearer market signals would prompt a private sector response that would result in allocative efficiency across the economy. The role of government under this new economic framework would be greatly reduced. The government would be likely to withdraw from much of its direct economic control function, though there would continue to be areas where "light-handed" regulation would exist, including the natural monopolies.<sup>36</sup>

#### IV. WHAT IS LIGHT-HANDED REGULATION?

Light-handed regulation means that public utilities in New Zealand have been deregulated in successive stages. They are no longer subject to explicit regulation, but are subject to competition legislation and regulations controlling information. The main controls over public utilities in New Zealand are the Information Disclosure Regulations adopted for each utility, and New Zealand's two competition statutes, the Commerce Act 1986 and the Fair Trading Act 1986. The Commerce Commission is the enforcer of competitive conduct in the market place.<sup>37</sup>

##### 1. Information Disclosure Regulations

Information disclosure is an important aspect of the government's approach to light-handed regulation. In order for light-handed regulation to be effective in deterring anti-competitive conduct, private parties or the Commerce Commission must have confidence that they can obtain information to investigate and, where relevant, prove anti-competitive behaviour. For this purpose, it needs information. In order to facilitate this information-gathering the government has decided regulation is best, since obtaining information through the court discovery process and the exercise of the statutory powers of the Commerce Commission may be costly or subject to substantial delay.<sup>38</sup> The information disclosure regulations support the development of competition by ensuring relevant pricing and interconnection agreement information is available to other industry participants. The regulations can achieve this by assisting

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<sup>35</sup> Supra note 28.

<sup>36</sup> Bollard, *New Zealand 1984 - 1991* (1992).

<sup>37</sup> Commerce Act 1986, s 8.

<sup>38</sup> Ministry of Commerce, *Telecommunications Information Disclosure: Discussion Paper* (1998).

in the efficient detection of anti-competitive behaviour and, in the telecommunications market, by assisting in the effective valuation of any Kiwi Share Obligation costs that entrants are required to contribute to as part of an interconnection agreement.

The Ministry of Commerce has made several suggestions for modifying the disclosure regulations in relation to telecommunications. While it considers that Telecom is complying with the regulations, it feels that the regulations need modifying in order to ensure that the public, competitors, potential entrants and the Commerce Commission have access to information about the monopolistic areas of Telecom's business. For example, the Ministry recommends requiring Telecom to publish information about their "0800" service, but deleting the requirement for the publication of information relating to international toll calls, since this area of the market is now substantially competitive. Moreover, the Ministry of Commerce recommends adjusting the information required about the local call services of Telecom to enable better comparison with OECD tariff comparison models. The Ministry of Commerce is proposing significant changes in the area of information disclosure relating to the Kiwi Share. Since the Kiwi Share obligation causes serious disputes between industry participants, the Ministry of Commerce would like to see the publication of costing data relating to the Kiwi Share, including any losses incurred by Telecom due to the Kiwi Share, so that entrants can evaluate the potential contribution to the Kiwi Share they would face on interconnection. The main recommendations that the Ministry of Commerce made in relation to the financial information disclosure are that separate statements for monopoly and contestable businesses be required and that a prescribed valuation method for Telecom's assets be implemented.

## 2. The Commerce Act 1986

New Zealand's Commerce Act generally seeks to prevent the effects of anti-competitive practices, in the belief that the most efficient allocation of resources and the best prices for consumers arise out of the free competitive process. The Act is not designed to generate more competition, but is rather aimed at preventing actions that undermine the competitive process. The Commerce Act has very general prohibitions on arrangements or practices that have an anti-competitive purpose or effect, though anti-competitive practices may well be tolerated if they achieve benefits to the public that outweigh the resulting reduction in competition.<sup>39</sup> As Cooke P (as he then was) said in the cellular telephone case,<sup>40</sup> the statutory object of promoting competition does not imply that unlimited competition is to be pursued at all costs, however wasteful of resources.

The main provisions relating to anti-competitive behaviour and restrictive trade practices are found in ss 27 and 36 of the Commerce Act. Section 27 prohibits contracts, arrangements or understandings that substantially lessen competition.

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<sup>39</sup> Part V of the Commerce Act deals with authorisations and clearances, relating to both restrictive trade practices and business acquisitions.

<sup>40</sup> *Telecom Corporation of New Zealand Limited v Commerce Commission* [1992] 3 NZLR 429.

Section 36 prohibits a firm with a dominant position in the market using that position for one of the proscribed purposes, namely restricting the entry of any person, preventing or deterring any person from engaging in competitive conduct, or eliminating any person from that or any other market. There has been an attempt to modify this provision by placing emphasis on conduct, rather than requiring an anti-competitive purpose, but the Commerce (Control of Dominant Position) Amendment Bill was defeated in its second reading. The Commerce Act also contains many other provisions designed to prevent anti-competitive behaviour such as price fixing,<sup>41</sup> resale price maintenance,<sup>42</sup> and preventing firms from acquiring other firms that will give them a dominant position in the market.<sup>43</sup>

## V. HAS LIGHT-HANDED REGULATION BEEN EFFECTIVE?

### 1. Reports on Regulation and Telecommunications

There have been numerous investigations of, and reports on the telecommunications market, but none have sparked regulatory reform. In 1992, the Commerce Commission produced a controversial report on the state of competition in the telecommunications market.<sup>44</sup> The Commission canvassed a number of interested parties, and produced its report on 23 June 1992. The report stated that in the Commission's view, there were a number of obstacles to the development of competition, many of which have subsequently been resolved. However, some issues still remain: the need for prompt interconnection to the network on commercially realistic terms, the bundling of products and/or services by Telecom and the Kiwi Share Obligation.

The Commission considered that neither the disclosure regulations nor the Commerce Act were adequate to protect potential entrants from Telecom exploiting its position. The Commerce Act is not specifically designed to cater for natural monopoly industries and the disclosure regulations are too general to be of assistance. The Commission's conclusion was that the Commerce Act may be of some help in removing the obstacles to the development of competition in telecommunications, but is protracted, expensive and uncertain, and has definite limitations in its scope.

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<sup>41</sup> Commerce Act 1986, s 30.

<sup>42</sup> *Ibid* s 37.

<sup>43</sup> *Ibid* s 47.

<sup>44</sup> Telecom challenged the Commerce Commission's authority to perform a broad investigation into a market on their own initiative without having a specific complaint. Telecom's challenge was ultimately upheld in the Court of Appeal (*Commerce Commission v Telecom Corporation of New Zealand Ltd* [1994] 2 NZLR 421), the Court stating that the Commission's report had all the characteristics of a formal Commission of Inquiry and there was no express power under the Commerce Act permitting such an inquiry in contrast to explicit powers contained in other legislation such as the Fair Trading Act and the Securities Act. Nevertheless, the report still contains valuable information.



The Minister of Communications responded by denouncing the report as “superficial”.<sup>45</sup> Thus, we have seen no change to the regulatory structure of the telecommunications industry.

Both the New Zealand business sector and the public became sceptical of the benefits of light-handed regulation after the decision of the Privy Council in the *Telecom v Clear* case.<sup>46</sup> In response, the Ministry of Commerce produced a report on light-handed regulation in 1995 that addressed several concerns raised by the Privy Council’s decision.<sup>47</sup> These included the operation of the Baumol-Willig rule in New Zealand access disputes, the issue of the Kiwi Share Obligation and how the costs of the Obligation should be split and the appropriateness of reliance upon the Courts and the Commerce Act. While several suggestions were presented for ways to deal with these issues, there has been little substantial change to the regulatory regime as a consequence.

The Todd Telecommunications Consortium produced a report, commissioned by Clear, in November 1998.<sup>48</sup> The report is very critical of the New Zealand telecommunications industry, stating that competition has not developed as well as in other nations that have adopted a more regulatory approach to the introduction of competition. The report also states that compared to the OECD average, prices are too high and Telecom is making monopoly profits. Furthermore, it claims that the Kiwi Share Obligation is costless, since Telecom is making substantial profits from the local call service anyway. They maintain that technology will not erode Telecom’s monopoly since the fixed network will always be needed. The report calls for regulatory change to assist competitors and ensure easier access to the network, but is rather vague on exactly what form that regulation should take. The report has been denounced by both Telecom and the Minister of Communications, Maurice Williamson, as being biased.

## 2. Litigation versus Regulation

In the telecommunications industry we have seen the continued legal wrangle between Telecom and Clear, with neither side preparing to give an inch. The private and public cost of this litigation must be enormous. A 1995 Listener report stated that court battles have cost Clear \$4m in legal bills.<sup>49</sup> Meanwhile, Telecom is achieving unprecedented profits, second only in return on equity amongst the international telecommunications firms in 1995 to Hong Kong Telecom. Nevertheless, the costs

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<sup>45</sup> “Minister Hammers Report on Telecommunications” *Otago Daily Times* 7 July 1992, 7.

<sup>46</sup> *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385.

<sup>47</sup> Ministry of Commerce, *Regulation of Access to Vertically-Integrated Natural Monopolies* (1995).

<sup>48</sup> Todd Telecommunications Consortium, *New Zealand Telecommunications: The State of Competition* (1998).

<sup>49</sup> Brown, “Telephone Turf Wars: What is the Clear/Telecom Fight Costing Us?” *Listener* 9 September 1995, 18.

of litigation must be compared with the cost of a regulator. A regulator is not only expensive in itself, but it also imposes distortionary costs. Since the regulator is not omnipotent it cannot mirror the outcome of competition except by chance. It is therefore inevitable that there will be distortions. These distortions are costly, both in terms of loss of efficiency and sending the wrong pricing signals to potential entrants. For these reasons it is preferable, as a general rule, to rely on market forces to determine the most efficient outcomes, and to rely on regulation only if there is a high level of confidence that the factual assumptions on which it is based are correct.<sup>50</sup>

Scott suggested in a Competition Law and Policy Institute Workshop paper that litigation could be seen as a type of non-price predation.<sup>51</sup> In other words, companies could use litigation to raise rivals' costs and stall their entry, thus prolonging their monopoly profits. Moreover, the strategy is likely to give the firm a reputation as a hard competitor and thus discourage other potential entrants from entering the market. The Commerce Act has no specific provision to deal with this problem; cases would be brought under s 36 if a competitor believed the litigation was frivolous or vexatious.

### 3. Legal Disputes

There has been much litigation in New Zealand following the deregulation of the telecommunications industry in particular. The electricity industry has been less litigious, possibly due to its structure which creates high barriers to entry in itself.<sup>52</sup> The first case of note in the telecommunications industry was *Telecom Corporation of New Zealand Limited v Commerce Commission*,<sup>53</sup> where the Court of Appeal ultimately allowed Telecom to acquire the AMPS-A cellular telephone frequency, despite the Commerce Commission's earlier refusal to grant authorisation for the acquisition.<sup>54</sup> Although the Court of Appeal was split over whether Telecom was in a dominant position in the cellular market, all agreed that the public benefits warranted authorisation. BellSouth's entry was imminent, and no one else was now interested in the AMPS-A band. The Court of Appeal was of the opinion that the efficiency gains due to the transition of Telecom's cellular network from analogue to digital technology at minimal cost, and disruption outweighed any possible strengthening of its dominant position.<sup>55</sup>

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<sup>50</sup> Supra note 4.

<sup>51</sup> Scott, "Abuse of Judicial and Administrative Processes - An Antitrust Violation" (1992) 1 Competition Law & Policy Institute of New Zealand Third Workshop.

<sup>52</sup> One case involving the electricity industry was *Power New Zealand Limited v Mercury Energy Limited* [1996] 1 NZLR 686, [1997] 2 NZLR 669 (CA), where Power NZ contested the approval given by the Commerce Commission to Mercury's acquisition of its shares. The Court of Appeal ultimately upheld the decision of the Commission.

<sup>53</sup> Supra note 45.

<sup>54</sup> Commerce Commission Decision No 254 17 October 1990.

<sup>55</sup> Ahdar, "Battles in New Zealand's Deregulated Telecommunications Industry" (1995) 23 Australian Business Law Review 77.

The second major litigation involved the two main players in the telecommunications market, Clear and Telecom.<sup>56</sup> Clear complained that Telecom's proposed interconnection agreement was on such unfavourable terms that it constituted a misuse of a dominant position by Telecom under s 36 of the Commerce Act. Telecom consulted American economists, Professors Baumol and Willig, who devised the Efficient Component Pricing Rule, which maintains that Telecom should be able to charge a price that makes it indifferent between completing the call itself or connecting the call to the Clear network. The rule is based on the assumption that Telecom is charging itself the same price for access to the network as it charges competitors, such as Clear, so only efficient entry will occur. Ultimately the High Court accepted the Baumol-Willig rule as being more likely than the alternatives to improve efficiency and promote competition, and thus Telecom could not be said to be in breach of s 36.

Clear subsequently appealed this decision, and the appeal was unanimously allowed by the Court of Appeal.<sup>57</sup> However, Telecom was successful in its appeal to the Privy Council. Lord Justice Browne-Wilkinson delivered the Board's unanimous opinion,<sup>58</sup> approving the use of the Baumol-Willig rule on all counts. The Board stated that it was the correct method of pricing on theoretical grounds. The hypothetical non-dominant firm in a competitive market, if asked to supply a component of a service to a competitor, would price it on the basis of opportunity cost. Telecom therefore could not be faulted for doing likewise.

This decision has been criticised by commentators,<sup>59</sup> and indeed the government itself denounced the Baumol-Willig rule. While the High Court and the Privy Council relied on the ability of Clear to compete prices down, thus lowering the price it paid for interconnection, in reality Telecom would have no incentive to lower its prices since it could maintain them at the monopoly level and be subsidised by Clear.

A third dispute occurred when Saturn attempted to enter the local residential calling market in Lower Hutt by laying its own lines and bypassing Telecom's monopoly in this area. Telecom rapidly lowered their rental to residential customers in the Lower Hutt area only. Saturn contended that Telecom was practising predatory pricing - the practice of an incumbent lowering their prices below cost in response to entry in order to force the entrant out of the market. The Commerce Commission investigated Saturn's claim of predatory pricing, but declined to take any action against Telecom, as there was no evidence that Telecom was pricing below cost. The Commerce Commission stated that regional pricing and offering reduced prices selectively are common responses, used by businesses that are not dominant, to a new entrant or increased competition.<sup>60</sup> Since a non-dominant firm would act in this way it is not illegal for a dominant firm to do so.

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<sup>56</sup> *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* (1992) 5 TCLR 166.

<sup>57</sup> (1993) 4 NZBLC 103,340.

<sup>58</sup> Supra note 56.

<sup>59</sup> Supra note 28.

<sup>60</sup> Commerce Commission, *Commission Will Not Intervene in Telecom Move to Match Saturn Prices*, Media Release 1998/61 (1998).

Telecom is currently in an informal dispute with Clear over the terms of access to the local loop controlled by Telecom. Clear needs access to the local loop in order to provide a domestic local calling service to complement its toll calling service. However, while Telecom is willing to allow Clear access to the local loop, it is imposing certain conditions that Clear finds unacceptable. Telecom is bundling the switching service with access to the local loop and requiring Clear to purchase both in order to have access to the local loop. Clear is disputing this, since they want to install their own switches, which is economically feasible, while installing a new local loop is not. This dispute has not been resolved to date.

#### **4. The Success of Light-Handed Regulation**

Since regulation is a substitute for competition, it would appear that the New Zealand approach would be the most successful way of transforming the public utilities from regulation to competition, and thus ensure efficiency. Many commentators have questioned whether competition and regulation can coexist,<sup>61</sup> and in New Zealand the government has decided that they cannot. Nations such as the United States, Australia and the United Kingdom, which have adopted the approach of ensuring competition through regulation, believe that since parts of the public utility industries remain naturally monopolistic, these parts will create substantial barriers to entry if unregulated, thus restricting competition in the contestable parts of the industry. New Zealand's approach, however, maintains that the dictates of the market will ensure competition will survive and that imposing regulations to deal with certain aspects of the market is inconsistent with competition and efficiency, and will distort markets and reduce the benefits from competition. Individual firms are better equipped to make efficient decisions than a regulator faced with bounded rationality. Moreover, the industries are evolving so rapidly that neither interventionist laws nor any regulatory body can keep pace. The recent proposed Commerce Act amendment to control electricity lines business prices seems anomalous when viewed against this ideology.

It has been eleven years since the telecommunications industry was deregulated and five years since the electricity industry was deregulated. In that time we, as domestic consumers, have seen little benefit from the promised effects of competition in the electricity industry. The government has conceded this and is currently changing the structure of the industry to stimulate competition. In the telecommunications industry, we have benefited from competition in the toll market and the cellular communications market, where prices are substantially lower, though we still rank in the middle of the OECD. Productivity improvements have also been impressive. While we have yet to see the benefits of true competition in the local market, overall competition in our deregulated utilities has rivalled that of overseas countries which have chosen to foster competition through regulation.

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<sup>61</sup> Kahn, "Can Regulation and Competition Coexist? Solutions to the Stranded Cost Problem and Other Conundra" (1994) 7(8) *Electricity Journal* 23.

New Zealand's approach, compared to the more heavily regulated approach of other Western nations, has been more effective in fostering competition, since our industries, especially telecommunications, have developed while dealing with competitive market forces. Thus, efficient industries have evolved naturally, rather than being artificially created. In addition, one cannot say that the industries of Australia, the United Kingdom, and the United States will not face the same problems that New Zealand has faced once they remove their regulatory structure. Although some will argue that New Zealand's approach may have been socially costly, particularly in the telecommunications industry, moving to a competitive market structure naturally entails costs, and New Zealand's approach is arguably better in the long term for developing efficient industries. Splitting the line ownership and retail activities upon corporatisation may have reduced these costs, for the lost economies of scope would have been outweighed by the avoided litigation costs for interconnection. Nevertheless, the legal precedents established in telecommunications regarding access may be of value to other industries, such as electricity and gas.

## VI. PROPOSALS FOR CHANGE

### 1. Industry-Specific Regulation

It is clear that we cannot go back to heavy-handed regulation, at least in the telecommunications market, since a regulator is too costly. Furthermore, the telecommunications market has operated for too long without a regulator, so regulation would likely be less than effective now. A regulator has bounded rationality - it simply cannot take in all the relevant information and replicate the efficient outcome of the market. Nevertheless, it may be that industry-specific regulation is appropriate if limited to two areas: ensuring fair treatment for consumers who lack competitive alternatives; and non-discriminatory access of competitors to bottleneck facilities.<sup>62</sup> If firms set interconnection charges non-cooperatively there will be double marginalisation and a final price above the monopoly price. If the firms are cooperative, this leads to collusion, again not socially beneficial.<sup>63</sup> Thus, an industry-specific regulator may be able to avoid these social costs by regulating interconnection. This regulation would have to be non-invasive, so that allocative efficiency is not distorted. It would also need careful monitoring, since technology may rapidly render it obsolete.

However, the current situation may be superior since the competition laws seek to create or maintain the conditions of a competitive marketplace, rather than replicate competition.<sup>64</sup> Further, an industry-specific regulator is prone to capture by the

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<sup>62</sup> Ibid.

<sup>63</sup> Newberry, "Privatisation and Liberalisation of Network Utilities" (1997) 41 *European Economic Review* 357.

<sup>64</sup> *Supra* note 15.

industry it regulates. Generally, they end up serving the industry participants' interests rather than the interests of society. Moreover, the notion of introducing numerous industry-specific regulators is at odds with the very reason for micro-economic reform, which is to remove regulatory restraints in order to facilitate competition. Finally, an industry-specific regulator would be in danger of taking too narrow a view, rather than achieving an economy-wide perspective.

BellSouth,<sup>65</sup> unlike Telecom, would like to see some form of regulator, but only in the area of numbering. It would like to see an independent numbering plan for New Zealand, and a body to administer the telecommunications numbers. The problem stems from the fact that Telecom claims to have bought the right to the current numbering system when it acquired the telecommunications assets that originally belonged to the Post Office. BellSouth rightly maintains that it is unacceptable to allow one player to dictate the development and use of the industry through control of the most central element of that industry - telephone numbers.<sup>66</sup> This independent regulatory body would not affect the efficiency of the market-based industry since it would not be determining prices, but simply ensuring fair access to a necessary resource.

Another option would be to introduce more regulation, but without an industry-specific regulator. The regulations would lay down specific rules for interconnection and access charges. A regulator would not be needed because each participant would enforce the regulations against each other. This would prevent much of the litigation since the litigation has stemmed from an unclear picture of each party's legal rights.

## 2. Amendments to the Commerce Act

BellSouth has suggested that the Commerce Act be amended to provide a better definition of "use of a dominant position" in s 36 by changing the wording to require "effect or likely effect", rather than the purpose test currently imposed.<sup>67</sup> It maintains that the purpose test defeats the intention of the section, since proving purpose is almost impossible. This means that firms breaching the Commerce Act are unlikely to be penalised under the current test. However, these claims have little validity in the face of successful prosecutions by the Commerce Commission. Furthermore, the Australian equivalent relies solely on a purpose test and they have had little difficulty securing prosecutions where appropriate.<sup>68</sup> Legislation to effect this change was defeated on its second reading in the House.<sup>69</sup>

New Zealand could amend the Commerce Act to include provisions specifically targeted at the telecommunications industry in particular or at utilities in general.

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<sup>65</sup> BellSouth, *Competition Quartet, Four Measures to Improve Competition in Business* (1998).

<sup>66</sup> *Ibid.*

<sup>67</sup> *Ibid.*

<sup>68</sup> Trade Practices Act 1974 (Australia), s 46(1).

<sup>69</sup> Commerce (Control of Dominant Position) Amendment Bill 1999.

This is the Australian approach, where the telecommunications industry is subject to both the general competition provisions and industry-specific provisions in the Trade Practices Act. This may be necessary because of the unique characteristics of the developing telecommunications market: competitors in downstream markets are dependent on access to a network controlled by the incumbent; there is the possibility of predatory cross subsidies by the incumbent; and the incumbent, Telecom, utilises informational advantages stemming from control of the local access network to cross-market its services.

There are substantial disadvantages to specific provisions as well. If the provisions are ambiguous, there is the obvious potential for disagreement between the general and the specific provisions, leading to more litigation. The definition of “telecommunications market” would have to be drafted extremely carefully in order to include only the market elements that are non-contestable. Moreover, it would be very easy for the definition of “market” in the general provisions, and the definition of “telecommunications market” in the specific provisions to clash, causing significant interpretative difficulties. The need for specific provisions is arguable, since utilities are not the only markets characterised by vertical integration or substantial market power in one firm. These characteristics exist in other industries, and they are well controlled by the general provisions of the Commerce Act.

### **3. Tougher Disclosure Regulations**

Another suggestion has been tougher disclosure regulations. BellSouth in its Quartet booklet, suggests that the disclosure regulations should be adapted to achieve their intended aims; in particular to ensure Telecom discloses price and cost information relating to transactions involving any non-contestable elements, while at the same time making the information more useful and easier to enforce by better describing the services for which pricing and discounts must be disclosed.<sup>70</sup> This is similar to the recommendations of the Ministry of Commerce.<sup>71</sup>

### **4. Restructuring Telecommunications**

Another option would be to restructure the telecommunications industry along the same lines as the electricity industry.<sup>72</sup> Because of the lack of competition to date in the electricity industry, the government has been forced to split the natural monopoly part of the industry from the contestable part. However, it may be too late for such restructuring in the telecommunications market, since the government sold the network with Telecom eleven years ago. Restructuring would unduly and adversely affect

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<sup>70</sup> Supra note 66.

<sup>71</sup> Supra note 33.

<sup>72</sup> Supra note 56.

Telecom's shareholders, even though it would bring benefits in the form of competition. Australia has recognised the benefits of restructuring, since their Competition Principles Agreement between States provides that before introducing competition to a market traditionally supplied by a public monopoly, the State or Territory government will take a review of, among other things, the merits of separating any natural monopoly elements from potentially competitive elements of the public monopoly.<sup>73</sup>

## **5. Industry-Funded Referee**

An industry-funded referee would be a form of alternative dispute resolution. However, although such a referee may be more efficient than litigation, disputes may still ultimately end up in the courts. An industry-funded referee will not function properly unless the participants are willing to compromise, and reach agreements quickly and easily. This problem has been illustrated in the telecommunications industry, where arbitration and mediation have not as yet been successful, since the adversaries appear unwilling to compromise.

## **6. Code of Conduct**

The industry itself could adopt a code of conduct that it would draw up as a whole and agree to abide by. This would ensure that potential entrants as well as the existing participants know the rules by which the industry operates. Any one firm could take action against the other for breach of contract if they do not obey the code. This would possibly solve interconnection disputes once and for all, since all the participants would specify how interconnection disputes are to be dealt with and the formula for access pricing would be specified, with a review period included to account for the changing technology of the industry. There are potential problems with this concept, however. Most notably, Telecom would be in a strong position to dictate the content of the code of conduct, being by far the most powerful player in the market. Furthermore, codes of conduct are notoriously ambiguous, since they must account for unforeseeable situations. There is, therefore, a potential for more litigation to result.

## **7. Essential Facilities Doctrine**

The essential facilities doctrine, or prime necessity doctrine, is well recognised in the American courts, but it has yet to be fully accepted in the common law

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<sup>73</sup> Nagarajan, "Reform of Public Utilities: What About the Consumer?" (1994) 2 *Competition and Consumer Law Journal* 155.



jurisdictions. It has been judicially recognised in New Zealand,<sup>74</sup> but has not made the impact on our jurisprudence that it potentially could. The essential facilities doctrine applies when an essential, not merely desirable, facility is controlled by a monopolist. The court will uphold the right of the competitor to access the essential facility at reasonable cost.<sup>75</sup> However, this doctrine would seem to be ideologically opposed to New Zealand's light-handed regulatory structure.

The Hilmer Report recommended that Australia legislate a version of the essential facilities doctrine. Its conclusion was that in some industries, such as telecommunications and electricity, there is a strong public interest in ensuring that effective competition can take place, without the need to establish any anti-competitive intent on the part of the owner for the purpose of the general competition rules.

The doctrine was judicially approved in *Auckland Electric Power Board v Electricity Corporation NZ Ltd*, where the court stated that it was "not in dispute" that at common law a monopoly supplier of an essential commodity is under an obligation to supply, and to supply at a reasonable price.<sup>76</sup> Some commentators have suggested that the doctrine has been expunged by the passing of the Commerce Act.<sup>77</sup> However, it has been consistently affirmed in New Zealand alongside competition legislation dating back to the Commercial Trusts Act 1910.<sup>78</sup> Although the Commerce Act 1986 is a far more comprehensive regime, the doctrine arguably survives. There is no provision in the Act that explicitly deals with the subject of the essential facilities doctrine, so there seems no reason why litigants should not rely on it.<sup>79</sup> The issue is currently before the Court of Appeal in *Vector Ltd v TransPower NZ Ltd*.<sup>80</sup> The case was heard early in August, but judgment has been reserved.

In *Auckland Electric Power Board v Electricity Corporation NZ Ltd* - a precursor to the *Vector* litigation - the Privy Council expressed disapproval of the continued application of the doctrine, despite the Court of Appeal's apparent approval. The High Court in *Vector*, consisting of Williams J and Dr Brunt, held that the doctrine had been ousted by the Commerce Act and the SOE Act. The Courts interpreted the Acts as indicating Parliament's intention that the doctrine would not survive. Since the mid-1980s New Zealand has opted for a light-handed regulatory regime as encapsulated in the Commerce Act and SOE Act. Direct intervention is plainly intended to be a last resort. Significantly, no role has been spelled out for the courts other than in a conventional appellate setting.

It appears that there is no room for the essential facilities doctrine in our regulatory structure. The tenor of the legislation is that parties themselves determine the prices through bargaining and competition. Judicial price control is contrary both to this

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<sup>74</sup> *Auckland Electric Power Board v Electricity Corporation NZ Ltd* [1994] 1 NZLR 551.

<sup>75</sup> *Supra* note 13.

<sup>76</sup> *Supra* note 75 at 557.

<sup>77</sup> Farmer, "Transition from Protected Monopoly to Competition: The New Zealand Experiment" (1993-94) 1 *Competition and Consumer Law Journal* 1.

<sup>78</sup> For example, *Huntly Borough v South Auckland Education Board* [1963] NZLR 282, although the discussion of the essential facilities doctrine was obiter dicta.

<sup>79</sup> *Supra* note 56.

<sup>80</sup> *Vector Ltd v TransPower NZ Ltd* (CA 32,99).

approach and to Parliament's obvious disinclination to impose price control unless absolutely necessary. The doctrine is a form of regulation, albeit judicial rather than legislative. Where price control is deemed necessary by the Governor-General in Council, the government has delegated the price control function to the Commerce Commission.

A contrary argument is that the doctrine represents an important right of citizens to a secure supply at a reasonable price from monopolies. Parliament should not be able to implicitly oust this right. The doctrine could be seen as a method of private enforcement of reasonable prices, which is in keeping with the intention of Parliament to become less involved in the pricing decisions of public monopolies. However, it is still inconsistent with our light-handed regulatory regime and would entail courts setting prices. It remains to be seen what happens in *Vector*. However, the doctrine does not appear consistent with the legislation and ideology of our country.

## 8. Amending the Kiwi Share Obligation

The Kiwi Share Obligation has caused many disputes between the telecommunications industry participants. The only thing Telecom, Clear and BellSouth can agree on is that the Kiwi Share Obligation is distorting the market, forcing Telecom to cross-subsidise from business and international services, and preventing efficient entry into the residential market. There are internal contradictions in the Kiwi Share pledges, and external contradictions with the Commerce Act. The Kiwi Share seeks to attain certain access and distributional goals, while the Commerce Act seeks to attain certain competition goals. Neither regulatory force refers to the other, and there is no process for resolution if these disparate goals should conflict. Moreover, the Kiwi Share is not the most efficient way of ensuring universal access.

Although the social goals sought to be achieved by the Kiwi Share are valid - ensuring universal access - the Kiwi Share Obligation is unlikely to achieve this goal in the long term, since the Kiwi Share Obligation contains within it an incentive for further cost shifting. The undertakings unconditionally provide that local calls are to remain free, but the commitment to maintenance of line rentals is subject to the proviso that the overall profits of Telecom's regional operating companies are not unreasonably impaired. This would lead to business and residential consumers from all income strata subsidising residential consumers who make many long local calls. Raising the cost of line rentals will impact upon the ability of low income earners to have a phone in their home. It would be contrary to the goals of universal access and redistributional equity to insist upon free local calls at the expense of raising the cost of access for low income earners.<sup>81</sup>

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<sup>81</sup> Supra note 28.

## 9. Technological Changes

It is possible that technology may make the current natural monopoly problems obsolete in the telecommunications industry. In the future it may be feasible to communicate without requiring fixed lines. This would resolve the current interconnection dispute, but until such time, the nation would still face significant costs. Certainly, with the introduction of the Internet and fibre optics, it is becoming more economic to replicate lines in at least the major cities. This would erode Telecom's power in the market substantially, although the Todd Report maintains that a fixed network is still necessary.<sup>82</sup> It may also be possible to use the fixed line systems of other utilities to transmit telecommunications or electricity.

## VII. CONCLUSION

One of the biggest criticisms of a heavy-handed approach to regulation is that it diverts valuable resources from productive employment as participants engage in all manner of measures to exploit the regulatory process for individual gain, a process often referred to as "rent-seeking". This and other efficiency distortions are the reason many nations are slowly opening their utilities to competition. This belief in the efficiency of competition has infected the whole western world, although nearly every nation has a different way of promoting competition in utilities. New Zealand's approach has been rapid deregulation and "light-handed" regulation. The telecommunications and electricity industries are subject to the Commerce Act, which is the general competition statute, and information disclosure regulations, which ensure sufficient information is available to effectively monitor the industry incumbent. The recently proposed legislative changes in the electricity industry, imposing price control on lines businesses, is contrary to this "light-handed" regime, and could be interpreted as an admission of the need for regulation in true natural monopolies. It remains to be seen whether the Government will introduce a fresh bill in a further attempt to control electricity prices.

Rent-seeking costs are still apparent in New Zealand as participants seek to take advantage of the fragmented system of formal and informal regulation. Valuable resources are diverted to enormously expensive and protracted litigation, the determination of which seems to rarely provide any finality for the participants but leaves open further avenues for rent-seeking activities. Despite the obvious social costs associated with these rent-seeking activities, it is undeniable that we have also benefited greatly from deregulation. These benefits have been apparent in the telecommunications industry, particularly in the toll call and cellular markets, and we hope to see substantial benefits accrue to New Zealand residents and businesses due to the electricity industry restructuring. However, there are still some areas of concern, most notably in the interconnection disputes that have plagued the telecommunications industry.

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<sup>82</sup> *Supra* note 49.

The cost of interconnection, including the cost of litigation and the time spent negotiating, could have been substantially avoided had the government restructured prior to corporatisation. If Telecom had been separated vertically by selling the network separately from the retail activities, the government may have made less money, but it would have saved the country more in the long run by avoiding litigation and ensuring successful entry into all areas of the industry. It appears that the government is attempting to avoid this mistake with the electricity industry.

While a return to regulation in the telecommunications industry is both too late and contrary to the reform policies of New Zealand government, there are other methods of ensuring adequate competition. Unlike the electricity lines industry, the telecommunications industry could not be subjected to price regulation since it has operated without such regulation for too long and such regulation would therefore be ineffective. Nevertheless, some reform is necessary. A review of the Kiwi Share Obligation is also needed, since it clashes with the Commerce Act. While we have seen substantial benefits from competition in the telecommunications industry to date, the residents of New Zealand would like to see more.