



**NEW ZEALAND INSTITUTE FOR THE STUDY  
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# **STRATEGIC INTERACTION UNDER ASYMMETRIC REGULATION: The 'Kiwi Share' In New Zealand Telecommunications**

**PRESENTED AT THE TELECOMMUNICATIONS POLICY  
RESEARCH CONFERENCE,  
GEORGE MASON UNIVERSITY, SEPTEMBER 27 2008**

**Bronwyn Howell**

*Research Associate, ISCR*  
<http://www.iscr.org.nz>  
[bronwyn.howell@vuw.ac.nz](mailto:bronwyn.howell@vuw.ac.nz)

*Lecturer, Corporate Management*  
*Victoria Management School*  
<http://www.vuw.ac.nz/vms/>

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# MANY DIFFERENT ASYMMETRIES

Regulation explicitly imposes obligations on one firm to which other firms are not exposed

Dynamic strategic interaction underpinned by asymmetric obligations

- entrants will seek to exploit regulatory asymmetry
- incumbents will seek to avoid costly exposure

Competition law also imposes asymmetric obligations/opportunities

- e.g. dominant firms must obey different rules/behave differently

Contracts rarely have perfectly symmetric obligations



# THE 'KIWI SHARE': ASYMMETRIC REGULATION IMPOSED CONTRACTUALLY

Contractual deed between government and the newly-privatised incumbent (1990)

Three limbs:

1. The 'price cap' obligation
2. The 'universal service' obligation
3. The 'free local calling' obligation

Reflected long-standing commitments to consumers & voters by former government owner

- arguably 'informal institutions' (Williamson, 2000)

Matter of public record

- competitors had full information about asymmetry



# 'KIWI SHARE' INEVITABLY SHAPED SUBSEQUENT STRATEGIC INTERACTION

## Participants:

- the incumbent (Telecom)
  - the entrants/competitors (Clear, TUANZ, ISPs)
  - the regulator (Telecommunications Commissioner)
  - the legislators (government)
1. Competitive entry and the 'universal service' obligation
  2. Technological change and the 'free local calling' obligation
  3. Risks arising when regulators/legislators fail to take account of asymmetric obligations



# 1. COMPETITIVE ENTRY

‘Universal service’ obligations antithetic to competition

High prices in urban areas to subsidise high costs in rural

- apparent ‘profits’ in urban areas induce price-based competitive entry
- incumbent loses market share and ability to subsidise high-cost consumers – entrants get ‘free profits’
- unless incumbent can ‘tax’ entrants to recover lost profits, then must raise prices => loses even more market share
- entrant gains all urban market share, incumbent has only rural market share, must charge at least cost-based prices
- two-priced market – ‘undoes’ any policy intention to have universal service pricing



# CLEAR ENTERED IN 1991

Sought interconnection agreement with Telecom

Telecom responded with offer based on ECPR

- includes component to recover costs of social obligations

Clear alleged Telecom's prices are anticompetitive

- ECPR prices exceed long run average cost
- Telecom alone must bear 'Kiwi Share' costs

Three court cases

- High Court – ECPR acceptable
- Court of Appeal – ECPR prices anticompetitive as contain element of rent (i.e. Telecom must bear 'Kiwi Share' costs uncompensated – 'undoing' universal service policy)
- Privy Council – ECPR prices competitive; Clear has not demonstrated prices are above costs (including Kiwi Share costs)



# RECOURSE TO POLITICAL STRATEGISING

Clear litigation difficult to rationalise strategically

- Government must have intended universal service to remain in place
- hence ‘Kiwi Share’ costs MUST be passed on to entrants

Entrant response

- repeated political lobbying to impose regulation and non-ECPR prices on Telecom

Lobbying ultimately successful

- 1999 election – new government
- 2000 Inquiry recommended installing Telecommunications Commissioner, setting TSLRIC prices and levying ‘Kiwi Share’ costs on Telecom alone



# (SOME) ECONOMIC AND POLICY RATIONALITY PREVAILS

## Telecommunications Act 2001

- industry-specific regulation imposed (TSLRIC pricing)
- Telecom must continue to honour the terms of the “Kiwi Share’ agreement
- but ‘Kiwi Share’ costs explicitly stated in the legislation (renamed TSO) to be a charge on the entire industry (Commissioner sets tax annually and uses proceeds to compensate Telecom)

## TSO tax remains unpopular with entrants

- continued lobbying
- another review in 2008



## 2. TECHNOLOGICAL CHANGE

### ‘Free local calling’ and the emergence of the Internet

- no user charge for dial-up component of internet access
- huge increase in minutes of PSTN use - totally uncompensated due to ‘free local calling’
- NZ one of most connected and highest-using internet countries in OECD

### Interconnection contract (ICA) arbitrage

- 5 year agreement in 1996; internet growth begins 1997
- Telecom connects over 97% of telephony customers
- entrants sign on majority of ISPs (sharing ICA cash flows)
  - highest-using consumers most valuable => incentives for ISPs to share ICA revenues with consumers
  - ISP ‘price war’



# IMPLICATIONS FOR TELECOM

## Adverse selection

- highest internet users signed on to competitor ISPs
- huge cash losses
  - line rental \$30 per month; average ICA loss \$36 per month for average consumer with competitor ISP (but more than this due to selection)

## Strategic response

- introduce ADSL early (January 1999), high quality (2Mbps), cheap (3<sup>rd</sup>-lowest prices per mbps in OECD in 2000, widespread (85% of lines by 2002) universal prices, two part tariffs (prices possibly below cost as benchmark was not break-even but extant ICA losses)
- to induce rapid substitution by the most costly (i.e. high-volume) users



# BUT INSUFFICIENT TO STEM LOSSES

Telecom sought variation to 'Kiwi Share' ('0867')

- only 10 hours 'free' internet connection per month, thereafter 2c.minute (ICA charge) for all consumers dialling an ISP not on Telecom's IPNET internet network
- approved by Minister in 1999
  - 'old' minister- one of last acts before being voted out of office

ISPs lobbied, alleging anticompetitive action

Commerce Commission laid charges under the  
Commerce Act

- '0867' finally (2008) found not to have breached Act



# ICA LASTED FULL 5 YEARS

Replaced by 'bill and keep' in 2001

'Bill and keep' replaced by TSLRIC-based regulated price in 2002 (1.13c/minute)

Dial-up internet usage peaked in 2003

- 850,000 accounts
- average of 35 hours per month on line per account

ADSL prices, quality, availability amongst most competitive in OECD

- yet NZ broadband uptake is only 22<sup>nd</sup> of 30



# 3. REGULATORY AND POLITICAL RISK

## Low broadband uptake

- entrants allege a competition ‘problem’ – Telecom exerting dominant position
- petition for full local loop unbundling

## LLU Inquiry 2003

- total welfare benchmark
- Commissioner recommends NO unbundling
  - static efficiency - benefits not sufficiently compelling given risks
  - dynamic efficiency – NGN investment imminent
- but mandates limited bitstream unbundled product instead
- conditional on Telecom meeting broadband uptake obligations
  - 250,000 connections by December 2005, 33% sold by entrants

Entrants very unhappy – wanted full LLU



# ENTRANT STRATEGIES

## Few incentives to sell bitstream connections

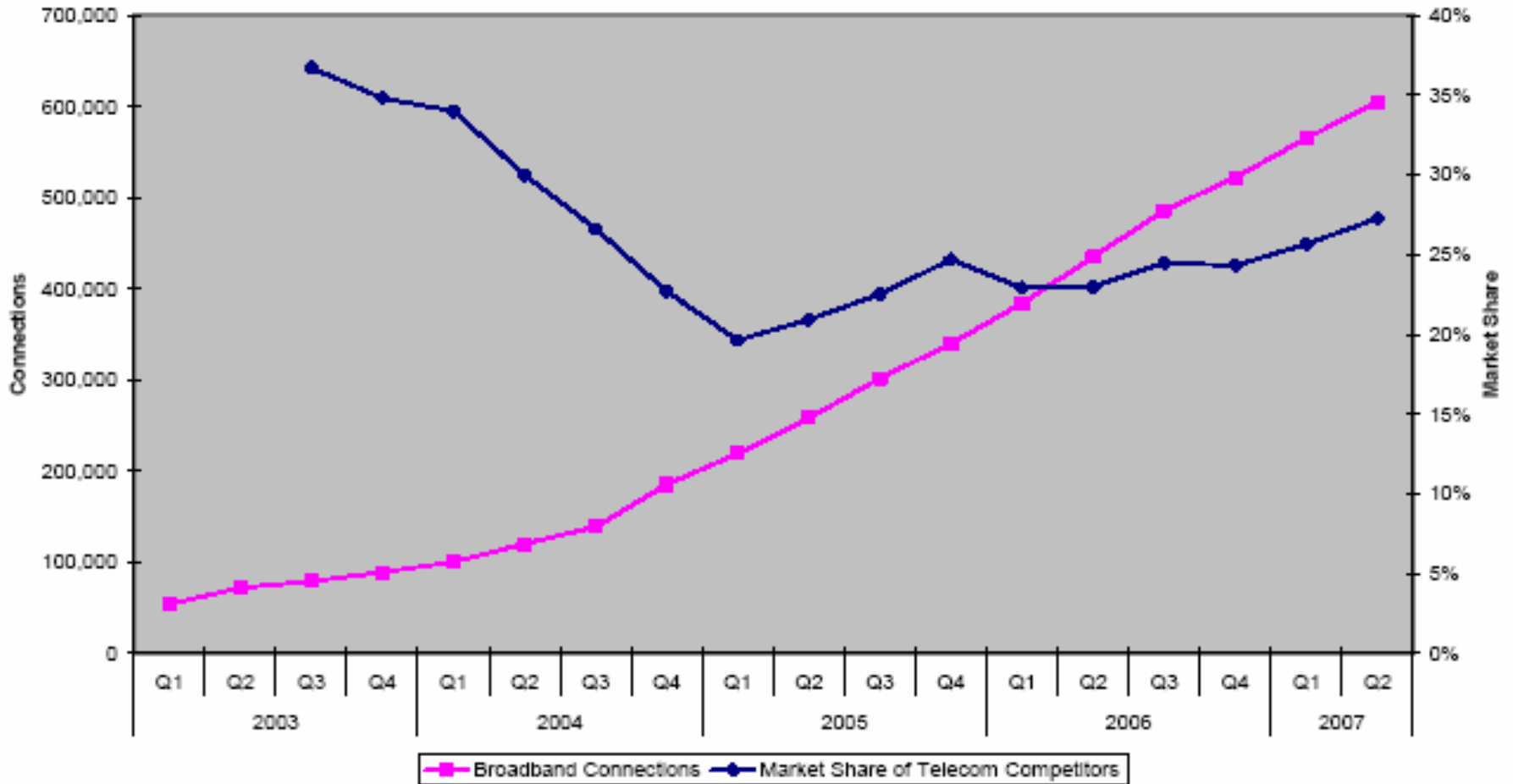
- doing so makes it more likely Telecom will meet targets, full LLU not implemented

## Price considerations

- Telecom ADSL connections priced low to induce substitution
  - two-part tariffs include low connection prices and positive usage prices
  - entry level ADSL connections \$29.95 per month (tied to Telecom fixed line service; likely below cost)
- unbundled bitstream connections \$27.87 per month
  - interconnection margins up to \$11.30 per month at 1.13 c/min
- more profitable for entrants to sell dial-up connections



## New Zealand ADSL Market 2003-2007



# RETURNS TO LOBBYING

Propensity for political responses favouring ‘third parties’ when government contracts do not appear to be delivering desired political outcomes (Spiller, 2008)

## 2005 General Election - November

- competitiveness of telecommunications market a significant issue
- apparent abandonment of the efficiency objective

## 2006 ‘Stocktake’ - May

- Telecom failed to meet obligations
  - Sold 11.6% more connections than targeted
  - but only 25% sold by entrants
- LLU mandated
  - market “insufficiently competitive”
- functional separation April 2007



# POLITICAL AND COMMERCIAL CONSEQUENCES

## ‘Tied’ ADSL and flat rate fixed line services

- dial-up user substitutes to ADSL – reduces fixed line usage dramatically but pays same high connection price => fixed line costs reduced leaving surplus to subsidise ADSL connection

## In ‘unbundled’ world

- competition now for fixed line customers (i.e. for the subsidies to ADSL services)
- high dial-up users and existing ADSL consumers now the most lucrative

## Implications for Telecom

- margins to subsidise ADSL reduced => dial-up prices must rise
- two price rises already in 2008



# IMPLICATIONS

Historic asymmetric obligations in fixed line market continuing to affect patterns of competitive interaction

“Free local calling” politically embedded

- leads to different strategic interactions
- cannot ignore its effects in generating observed outcomes

Regulators/legislators must be aware of potential competitor strategies as well as the dominant firm’s potential exertion of dominance

- market share observations consistent with insufficient competition also consistent with strategic interaction as a consequence of asymmetric fixed line obligations
  - competition ‘solutions’ will not have predictable effects in such cases
  - must consider much wider strategic implications when intervening in the market

