Clarification as to what welfare standard I think is required for the Commission's analytical framework of potential TSLRIC and/or WACC uplifts

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1. Chorus has asked for my views on the following issue: in the Commerce Commission's update paper on its approach to testing and quantifying the need for any potential uplifts to the TSLRIC price for UCLL and/or the mid-point WACC for UCLL and UBA, the Commission proposes to consider "the potential gains and losses in consumer welfare, rather than total welfare".[1] The Commission justified this approach in part to a statement in my earlier report (Hausman, 2014) that "Economists have determined that consumer welfare should be the goal of regulation". Chorus has asked me to clarify what welfare standard I think is required for the Commission's analytical framework of potential TSLRIC and/or WACC uplifts."
2. In ¶ 6 of my report my first conclusion was: Investment in telecommunications infrastructure leads to new services and improved quality in existing services. Academic research has found very large welfare gains to consumers and business end-users from new and improved telecommunications services.
3. I believe that this conclusion is uncontroversial and accepted my most academics and telecommunications policy analysts worldwide. Consumers benefit from new

[1] Commerce Commission "Agenda and topics for the conference on the UCLL and UCBA pricing reviews" (April 2015) ¶ 34.

services and improved quality of services as I have found in my academic research and as other academic researchers have found. In my report in ¶ 11 I discuss recent research from the U.S. which finds consumer welfare gains of approximately $18 billion per year from improved internet speeds.

4. While my view is that the consumer welfare standard is the correct standard to evaluate telecommunications policy and regulation, it is crucial to understand the correct time frame for the evaluation of consumer welfare. Over time, increases in consumer welfare will not occur unless significant investment occurs. And since most investment in telecommunications is sunk cost investment, the investment is riskier that much other investment. Thus, regulation must create correct economic incentives to encourage firms and investors to commit funds to investment.

5. In my view in concept of the "long-term benefit of end-users" (LTBE) the word "long-term" is very important because it incorporates the effects of investment. In economics "long-term" means taking into account a period long enough so that the capital stock changes, and is not fixed, as it is in the short-term.

6. In the short-term regulators can increase consumer welfare by choosing low prices for regulated services. However, this policy will not provide correct incentives for investment in the "long-term". The effects of this policy have been evident in the EU as I discussed in my report in ¶ 12-16 where strict price regulation has led to insufficient economic incentives for investment in higher speed fiber networks and advanced mobile technology. EU regulators have recognized this problem and are now attempting to increase incentives for new investment.[2]

[2] Prof. Cambini in his March 16, 2015 paper for the Commission concurs in my description of EU policy makers attempting to provide increased incentives for investment in telecommunications. (Cambini p. 2)

7. The Commission in its update paper states: “Our analysis of potential TSLRIC and/or WACC uplifts is based on the potential gains and losses in consumer welfare, rather than total welfare.” The Commission references my recommendation that a consumer surplus standard should be used. However, the Commission has misunderstood the use of the consumer welfare standard in the correct time frame. What I, and other economists mean, is consumer welfare over the “long-term” when the welfare increasing effects of investment and innovation have been taken into account.
8. The Commission disregards the “long-term” effects of its policy in ¶ 42 where it states: “…the deployment of the UFB is contractually committed and therefore the majority of these benefits are likely to emerge irrespective of whether an uplift is applied to the UCLL TSLRIC price.” This statement is only “short-term” in context. Firms will not have the correct incentives to make further investments in risky sunk cost telecommunications infrastructure if they are not appropriately rewarded. TSLRIC sets a price below the economically correct level accounting for risk as I have explained in my report and demonstrated in my academic research. Thus, in my view an uplift to TSLRIC is required in the framework of the consumer welfare standard.
9. While the Commission recognizes that its policies could have an effect on investment in ¶ 82, it does not take account of these considerations in its paper stating it wants to develop a quantitative framework. Given the crucial importance of innovation and new investment in terms of the “long-term” interests of consumers and “long-term” gains in consumer welfare, I conclude that this approach could well lead to significant harm to the “long-term” interests of consumers in New Zealand.

10. I also note that Prof. Cambini in his March 16, 2015 report for the Commission does not consider this issue since he assumes "when assessing a regulatory policy in the New Zealand scenario [the key issue] is not the impact of copper prices on the incentives to invest in fibre" (p. 5). Instead, Prof. Cambini assumes that the investment in the fiber network is contractually committed. Thus, he fails to take account of the "long-term" interests of consumers in terms of future investment incentive for investment in telecommunications infrastructure in New Zealand.

11. For example, in the U.S. both cable companies (e.g. Comcast) and telephone companies (e.g. AT&T) have spent billions of dollars and plan to spend further billions of dollars to upgrade their fiber networks as demand has increased with widespread use of streaming content. In the future New Zealand will require upgrades to its fiber networks with high probability. Thus, the "long-term" interests of consumers depend on investment incentives and regulatory policy. By not providing the correct risk-adjusted return for investments in these sunk cost investment Prof. Cambini disregards probably the most important economic factor in the "long-term" interests of consumers.

12. In conclusion, I find the consumer welfare standard is the correct welfare standard to use. However, the time frame for evaluation of consumer welfare must be correct. Consumer welfare over the "long-term" is what is important. Short term policy which does not provide correct incentives to invest will lead to decreased consumers welfare and decreased "Long Term Benefit to End-Users".

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