IN THE COURT OF APPEAL OF NEW ZEALAND

CA288/2008
[2009] NZCA 338

BETWEEN	THE COMMERCE COMMISSION Appellant
AND	TELECOM CORPORATION OF NEW ZEALAND LIMITED First Respondent
AND	TELECOM NEW ZEALAND LIMITED Second Respondent

Hearing: 23 - 26 March 2009

Court: William Young P, Hammond and Robertson JJ

Counsel: J A Farmer QC, G M Coumbe and J S McHerron for Appellant
D Shavin QC, J E Hodder SC and P R Jagose for Respondents

Judgment: 4 August 2009 at 10 am

JUDGMENT OF THE COURT

A. The appeal is dismissed.

B. Costs are reserved.

REASONS OF THE COURT

(Given by Hammond J)

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Introduction

[1] This is an appeal from a judgment of Rodney Hansen J and Mr Copeland, a lay assessor, after a 20-day trial in a competition law case in the High Court at Auckland: (2008) 12 TCLR 168. The Commerce Commission claimed that Telecom had contravened s 36 of the Commerce Act 1986, in that it made an unlawful use of a dominant position in a market when it introduced its "0867" telephone package in 1999. The High Court rejected that proposition.

The context of the case

[2] This case has formed part of a series of disputes between Telecom and Clear. It is convenient to first put the case in its overall context.

The privatisation process

[3] Until 1987 the public telecommunications system in New Zealand was a state monopoly. That system then became Telecom Corporation of New Zealand, a state-owned enterprise. In 1989 Telecom was privatised. The government sold off all shares except one controlling share, the "Kiwi Share". The sale included the national copper-based wire network. All providers of fixed or mobile telecommunication services required access to this network. Any new entrant would find this network uneconomic to duplicate. There was no immediate prospect of any new entrant into any national telecommunications market being able to bypass it by the use of fibre optic cable.

Light-handed regulation

[4] Many countries which have introduced private competition into a public system have given competitors or potential competitors statutory rights of interconnection into that system. New Zealand did not opt for phased privatisation. Nor did it confer any rights of interconnection to Telecom's fixed network. No statutory guidance was provided as to how a company which owned a national telecommunications network was required to sell access to this facility to someone else, who was not only a consumer, but a potential competitor.

[5] In what was then a world-wide trend towards telecommunication deregulation, nearly all countries thought it prudent to couple privatisation of the state monopoly and the emergence of competition with some form of industry specific regulation. Thus, for instance, independent bodies such as Oftel in Great Britain and Austel in Australia were set up to deal with the scenario where new entrants failed to agree on interconnection costs and conditions.

[6] In New Zealand the notion was – one commentator has described it as an "optimistic belief" (Ahdar "The Privy Council and "Light-Handed Regulation" (1995) 111 LQR 217 at 217) – that the industry should sort it out for itself as to how competitors should enter, and on what terms. If they could not, then resort could be had to the Commerce Act 1986, which is the competition law statute in this jurisdiction. The overall approach so laid down could fairly be described as "unique" in the western world.

Trouble begins

[7] Very early in the history of the deregulation of the telecommunication market(s) in New Zealand there was an agreement as to the toll market between Telecom and Clear, which was the first distinct rival to Telecom to appear on the scene. But then a significant dispute emerged as Clear began to challenge Telecom's monopoly by also seeking to enter into the local business calling market. This gave rise to a protracted struggle by Clear against Telecom in respect of Telecom's interconnection demands with respect to local access.

The interconnection dispute

[8] After extensive commercial negotiations, which began in 1991, there was lengthy litigation between these parties which led ultimately to a decision of the Judicial Committee of the Privy Council: *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385. At stake was what Telecom could charge Clear to interconnect with Telecom's networks in order that Clear's customers could communicate with Telecom's, and vice versa. Telecom "won" that legal battle. The commercial effect of the decision, which attracted its own share of controversy, was to allow Telecom to bill Clear far more than Clear had hoped for.

[9] The Privy Council appears to have exhibited some distaste for the notion that courts should somehow become quasi-regulators. But the alternatives were not easy: there was no apparent appetite for intervention at the governmental level and difficult agreements were going to have to be negotiated in a somewhat murky

context with, ultimately, the courts being pushed into the difficult position of being something of an ambulance at the bottom of the cliff.

The provenance of the 0867 dispute

[10] Indeed it was not long before there was a slop-over from the earlier litigation, in the form of the present dispute. Telecom's win in the Privy Council did lead, in 1996, to an interconnection agreement between Clear and Telecom. One aspect of that agreement was the payment of termination charges. A residential customer (X) on one network could make a call to another person (Y) on the other network: this could be a call from a Telecom customer to a Clear customer, or vice versa. The network used by X had to pay a per minute termination charge to the network used by Y. The practical effect of the Privy Council decision was that the termination charge paid by Clear to Telecom was higher than the other way around. This is because in practice most voice calls terminated on Telecom's much larger network. Hence Clear was making significant net payments to Telecom. In economic terms, this was a particularly happy position for Telecom to be in.

The advent of internet dial-up

[11] Technology routinely gets ahead of the capacity of the market, and commercial agreements, to deal with it, let alone the law. (See Hammond "The IBM Monopoly Case" (1979) NZLJ 316.) What happened in this instance is that residential internet dial-up use expanded very fast, and certainly well beyond Telecom's and Clear's expectations. Indeed, residential dial-up internet access became a major use of Telecom's local access network.

[12] Living as we now do in an everyday world of broadband, it is necessary to recall that dial-up internet had quite different characteristics from voice traffic. When parties communicated on a traditional telephone communication system, the traffic was flowing in both directions. In a very real sense therefore, it was "balanced". But internet traffic was totally different. A residential customer dialled

up all her calls with her internet service provider (ISP), but nothing originated back the other way. That is, ISP traffic was all "one way".

[13] If, therefore, the ISP was on the Clear network and its residential dial-up customer was on Telecom's network, Telecom had to pay a per minute termination charge to Clear. And, there were far more residential customers on Telecom's network. If, on the other hand, Clear had a successful ISP on its network, it could accumulate large termination charges from Telecom, based on Telecom's residential local access customers using a Clear ISP.

[14] Not only were there different characteristics in traffic flow but, typically, an internet call was a lot longer in duration than with voice traffic. And given that the charges were in per minute intervals the payments by Telecom to Clear became ever more significant.

[15] Clear and other ISPs took advantage of the world as it had become. They were able to keep their ISP charges to customers low, or even free, with Clear and the other ISPs sharing the termination charge revenue paid by Telecom. The High Court said that this created "perverse incentives".

[16] To complicate matters further, under the Kiwi Share agreement (KSO) with the New Zealand government, Telecom had no alternative but to supply to residential customers free and unlimited phone line access for a fixed monthly fee.

Telecom's solution

[17] Whilst it is not easy to fully grasp all the technological details, in commercial terms the solution adopted by Telecom can be concisely described. It brought into being a regime which encouraged residential customers (and ISPs based on the Clear network) to "migrate". This was done by using a dial-up number with the 0867 prefix. This meant that residential customers calling a phone number with the 0867 prefix would not be charged for their calls. But the ISP, which had agreed to accept 0867 calls, thereby lost its right to claim the termination fees. Telecom considered that the 0867 calls were outside the Kiwi Share obligations.

[18] Residential customers could however continue to access their ISPs using dial-up numbers other than those with the 0867 prefix. But if they did, they would have to pay two cents a minute (unless their ISP was Xtra, which was an ISP arm of Telecom) beyond 10 hours of internet use each month. The consequence of this was that the ISPs were necessarily driven towards the 0867 solution.

The dispute in a nutshell

[19] At heart, the claim in this case is that Telecom introduced the 0867 scheme to stem the outflow of termination charge payments but also in a sense to "deal to" its competitors by making life much more difficult for them. This, it is said, amounted to a misuse of Telecom's dominant position under s 36 of the Commerce Act, as it then stood. The broad argument is that Telecom had choices as to how it could proceed but that it took that which was most favourable to it and thereby reduced the very large payments it was making to Clear. And, it seems to be said, Telecom did not *have* to make choices which were so "hard-nosed" vis-à-vis its competitors.

The legislation

[20] Prior to its amendment in 2001, and as it stood for the purposes of this case, s 36 of the Commerce Act provided:

> **Use of dominant position in a market:**
>
> (1) No person who has a dominant position in a market shall use that position for the purpose of –
>
> (a) Restricting the entry of any person into that or any other market; or
>
> (b) Preventing or deterring any person from engaging in competitive conduct in that or any other market; or
>
> (c) Eliminating any person from that or any other market.
>
> (3) For the purposes of this section, a person does not take advantage of a substantial degree of power in a market by reason only that the person seeks to enforce a statutory intellectual property right, within the meaning of section 45(2), in New Zealand.

(4) For the purposes of this section, a reference to a person includes 2 or more persons that are interconnected.

[21] It will be observed that the provision has three elements:

- First, there is a "threshold": the impugned firm must have a dominant position in a given market; and
- Second, the impugned firm must have "used" that position; and
- Third, for an anti-competitive purpose.

[22] It is common ground that all of these elements have to be met by the Commission to succeed in this case.

The High Court decision

[23] The High Court determined that at the relevant time Telecom was dominant in the market for "fixed line retail phone services to residential customers" (at [54]). However, Telecom did not "use" that position in the relevant competition law sense. A non-dominant Telecom, in the competitive market which was assumed, would have been able to introduce the 0867 service. Therefore it had not breached s 36.

[24] Moreover, assuming that Telecom in fact used its dominant position, it did not do so for a proscribed anti-competitive purpose. The Court took the view that there was a hugely increased loading on Telecom's network and Telecom had to solve that problem in some way. The two drivers of Telecom's actions (network congestion and reducing the termination charges payable to Clear and other persons) were very much intertwined. If the termination charges were reduced, network congestion would be reduced too; congestion reduces because of reduced traffic. Further, by removing the "perverse incentives" which had been identified, the outcome was likely to be pro-competitive, at least for a time.

The arguments for the Commission, on this appeal

[25] Mr Farmer QC conveniently summarised the submissions for the Commission as follows:

> *Market definition*
>
> (a) The High Court erred in defining the relevant wholesale market as a market for terminating access only. The market is for network interconnection, encompassing both originating and terminating access.
>
> *Telecom's dominant position*
>
> (b) Having found that Telecom had a dominant position in the wholesale network access market in 1996, the Court was wrong to conclude that "changed market conditions", relating to Clear's ability to constrain Telecom, had negated Telecom's dominance by the time of introduction of 0867 in 1999.
>
> *Telecom's use of its dominant position – retail market*
>
> (c) Reflecting the Privy Council's division of opinion on the issue, the question of how the Courts should determine whether a defendant has used its dominant position warrants some reconsideration. The statutory question – has the defendant used its dominant position – is a factual one. Although analysing that factual question may be assisted by considering a counterfactual, it is submitted that the counterfactual should not be regarded as the sole test.
>
> (d) In the present case, if the statutory question – did Telecom use its dominant position in the retail market – is assessed as a conventional factual inquiry the answer is plainly yes. Telecom was able to impose the 2c/min IDC for the obvious reason it owned 99% of all residential access lines. The 0867 scheme was designed to incentivise residential customers to use an ISP with an 0867 number, and ISPs to use carriers who could supply an 0867 number. Customers had virtually no ability to move to a rival network. The conclusion that Telecom used its dominant position in the retail market is inescapable.
>
> (e) If a counterfactual test is applied as well, that analysis also demonstrates that Telecom used its dominant position in the retail market. It is submitted that the Court wrongly concluded that a firm not in a dominant position but otherwise in the same circumstances as Telecom ("Company X") would have been able profitably to introduce 0867. Company X would have lost residential retail customers to other carriers and it would not have been indifferent to losing those customers.

Telecom's use of its dominant position – wholesale market

(f) If the statutory question – did Telecom use its dominant position in the wholesale network access market – is applied to the facts, again the answer is yes. Telecom was able to assert that 0867 was outside the existing ICAs, and refuse to provide carriers with 0867 numbers unless they signed ITAs foregoing termination payments, because rival carriers had no choice but to interconnect with Telecom's ubiquitous access network.

(g) If a counterfactual test is applied that assumes Company X is non dominant in the wholesale market, that analysis also shows that Company X could not profitably have introduced 0867. Company Y (Clear) could decline to do business with Company X and buy wholesale network access from other carriers. Company X would not therefore have had the same bargaining leverage as Telecom. Neither Company U, nor the ISPs hosted by Company Y, would have had an incentive to abandon their existing contractual arrangements and sign up to the 0867 scheme.

Purpose

(h) In relation to "stated purpose", the Court wrongly found that the evidence did not establish that Telecom had an anticompetitive purpose.

(i) In relation to "inferred purpose", the Court did not apply the correct approach as stated by the Privy Council, which is to infer purpose from proof of use of a dominant position. The Court also wrongly discounted evidence of anticompetitive effects arising from 0867.

The KSO

(j) The Court correctly found that the Commission had established that in 1999 Telecom had a dominant position in the retail market for fixed-line telephone services to residential customers, and that the KSO did not remove that dominance.

[26] Mr Farmer further noted that the High Court analysis of the s 36 issues accepted that, overall, the 0867 initiative was a pro-competitive one. It accepted that:

(a) The combination of the KSO, the above-cost and asymmetric terminating payments in the ICAs, and the dramatic and unforeseen internet growth, led to "arbitrage opportunities" that were exploited by competing carriers and ISPs (through the "sharing" of termination payments) and created "perverse incentives" to boost dial-up internet traffic;

(b) The termination payments to competing carriers and the "resultant subsidies" to ISPs led to low (even zero) prices to consumers, were not the product of superior efficiencies, and were therefore not the result of true competition; and

(c) Telecom's introduction of the 0867 package, which led to the removal of the "arbitrage opportunities" and the "perverse incentives", was therefore pro-competitive, leading to an improved quality of service and greater dynamic efficiency.

The Commission says these findings were incorrect, for a variety of reasons.

The arguments for Telecom, on this appeal

[27] Telecom supports the High Court judgment, except to the extent that it contends that the High Court was entitled to conclude, and should have concluded, that Telecom was not dominant in the retail residential fixed line market.

[28] Broadly, Telecom submits:

(a) That there is no error in the High Court's understanding of the factual context;

(b) That the regulatory impact of the KSO negated any relevant aspect of dominance which could be attributed to Telecom in the market, in both practical and conceptual terms; and

(c) That the judgment did not misapply the counterfactual analysis in finding no use of any dominance.

[29] Mr Hodder SC submitted that the "unsurprising" conclusion of the High Court was that the introduction of the 0867 package in 1999 was normal commercial behaviour, and pro-competitive. The logic and general merits of that package were indicated by its acceptance in 1999 by the Kiwi Share holding Ministers and further by its adoption in the 1999/2000 interconnection agreements between Telecom and competing carriers and also in the regulatory regime associated with the Telecommunications Act 2001.

The law

Introduction

[30] This is in the main a "factual" dispute. But some issues relating to the proper approach to a case of this kind were raised by Mr Farmer. It is therefore necessary for us to say something further about the law.

The ultimate question

[31] Mr Farmer has to be correct that, at the end of the day, the question for a court in a competition law case such as this is a straight-forward one: whether the impugned firm has used a dominant position in a given market for an anti-competitive purpose. Responding to that question is however difficult. It is an evaluative exercise. Courts have had to work out how to approach that exercise and have utilised economic evidence in the undertaking of that task. But it needs to be kept firmly in mind that an exercise of this kind is still one of a relatively normal character for a court. Whether it be in valuation cases, competition cases, patent cases, or in many other areas of the law, courts have to resort to the assistance of experts, including economic experts. But the law does not thereby become transmogrified into one of trial by experts: it is for the Court, utilising such techniques as it can usefully and appropriately resort to, and on all the evidence which is led, to make the evaluative determination to which we have referred. As with any other case, the expert evidence simply goes into the pool of available evidence to assist the Court on the particular issues it has to resolve.

Competition

[32] Competition refers to a market in which a number of suppliers contend for sales, and a number of consumers (many more than suppliers) contend for available goods or services. Competition is considered a "good thing" for keeping suppliers on their toes and passing benefits along to consumers. This is to be contrasted with a

monopoly in which there is more or less complete control by one seller of the production or sale of a product or service.

[33] Somewhere in between is the halfway house of what is often called monopolistic competition where the question is routinely how concentrated an industry must be before its market power becomes injurious to the public interest. Or as it is sometimes put, when can an industry be regarded as "workably" competitive? In competition law cases, courts are given the difficult task of sorting out that issue. Some hesitation on the part of courts is unsurprising, given the conflict between goals of efficiency and equity, which is routinely a fundamental conflict within the sort of mixed economies to be found in most western countries, and certainly in New Zealand.

[34] For a long time, competition law theorists, lawyers and judges squabbled over how "competition" was to be defined. In perhaps the still classic work, *The Antitrust Paradox* (1978), Bork came up with five possibilities: the process of rivalry; the absence of restraint over one firm's economic activities by another firm; the state of the market in which the individual buyer or seller does not influence the price by his purchases or sales; the existence of fragmented industries in a market; and – Bork's preferred definition – a state of affairs in which consumer welfare cannot be increased by moving to an alternative state of affairs through judicial decree.

[35] Fortunately, that long-running and messy debate has been put to rest in New Zealand by s 1A of the Commerce Act. It specifically provides that the purpose of the Commerce Act "is to promote competition in markets for the long-term benefit of *consumers* within New Zealand". We emphasise this point because the then administration in New Zealand (which took a distinct and direct interest in the issues presently before this Court) was of the view that the interests of consumers in New Zealand would not be injured by the course Telecom was proposing to adopt.

Markets

[36] In a case of this kind it has always been necessary to define the relevant market or markets. For without such an exercise it cannot be determined whether a given party is "dominant" in that market, or to determine whether any use of that dominance was for an anti-competitive purpose.

[37] In everyday economics, a market is a mini system in which particular goods or services are exchanged at a price with the traders free to sell or not sell what they have for what they want.

[38] In New Zealand, we are again assisted by the statute. Section 3(1A) of the Commerce Act relevantly defined "market" in the following terms:

> A reference to a market in New Zealand for goods and services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them.

[39] This exercise involves identifying the smallest area of the relevant activity over which a hypothetical incumbent could exert market power having reference to the class of products, geographic area and the function of the particular activity. Plainly, for instance, one could not sensibly talk about a "telecommunications" market between these parties; indeed, that would be actively misleading. It would be an overbroad classification, and largely amorphous. What is at issue is a particular kind of telecommunication service. In this instance, the relevant geographic and functional dimensions were not in dispute but there was some dispute over what product is at issue. We will return to this issue later in this judgment.

Dominant position

[40] As it stood at the relevant time, s 3(8) of the Commerce Act defined a dominant position in the market. The provision stated that:

> … a dominant position in a market is one in which a person … is in a position to exercise a dominant influence over the production, acquisition, supply or price of goods in that market …

[41] The provision then went on to identify several mandatory factors to be taken into account in determining whether a person is in a position to exercise a dominant influence, including the share of the market, the technical knowledge and access to capital and materials that person had; the extent to which that person was constrained by the conduct of competitors or potential competitors in that market; and the extent to which that person was constrained by the conduct of suppliers or acquirers of goods and services in that market. This list was non-exhaustive.

[42] This Court said in *Telecom Corporation of New Zealand Ltd v Commerce Commission* [1992] 3 NZLR 429 at 434 that the term "dominant" has its ordinary meaning of a commanding, ascendant, governing, primary principle or leading influence. And in *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 at [67], this Court described "dominance" as the "economic concept of market power without sufficient constraint". That said, a dominant position is not one of *absolute* control or monopoly: *Port Nelson Ltd v Commerce Commission* [1996] 3 NZLR 554 at 574 (CA). As we have already noted, perfectly competitive markets likely never exist in practice. The focus has therefore almost always been on whether the dominant firm can set prices or conditions without *significant* constraint from competitors. Finally, although more than one firm may have some degree of market power, it has been accepted by this Court that only one firm can be dominant over each of the aspects of a market specified in s 3(8): *Transpower New Zealand Ltd v Todd Energy Ltd* [2007] NZCA 304.

Use

[43] It is important to be clear on the underlying problem which is sought to be addressed under this head. At rock bottom a solution has to be found to the delineation between a "bad" misuse of market power, and "good" competitive rivalry.

[44] One approach is to say that a dominant firm is, or should be, entitled just like everyone else to compete with its competitors. To hold otherwise would be to stifle competition. Why, or so the question is asked, should there be a protective shield over inefficient competitors?

[45] One reply to that is that powerful firms are not the same as their small firm competitors. Because of their economic strength they may do distinctive damage to the competitive process and therefore have "special responsibilities" (see Ahdar "Escaping New Zealand's Monopolisation Quagmire" (2006) 34 ABLR 260). Indeed, under European (EU) law, "special responsibilities" are placed on dominant firms. Bellamy and Child *European Community Law of Competition* (5ed 2001) at 9.068 puts it this way: "[dominant firms] may be deprived of the right to adopt a course of conduct or take measures which are not in themselves abuses and which would even be unobjectionable if adopted or taken by non-dominant undertakings".

[46] Whatever views may be taken on these issues of "high policy" – and we do not have to resolve them here – the Judicial Committee of the Privy Council was quite clear in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* (above at [8]) and *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* [2006] 1 NZLR 145, that in determining "use", resort must be had to what has often been termed a "counterfactual test". Under such a test, the Court establishes a scenario (the counterfactual) which assumes that the particular market is competitive. The question then is whether the impugned firm would have acted in the same way even if there were competitive market pressures. If the answer is "yes", the firm is not "using" its dominant position. Or in this case, if there was a non-dominant Telecom in the relevant market(s) as found for the purposes of this case, could it have done what it did? If "yes", that is the end of the case.

[47] Several points need to be made here. First, it has to be acknowledged that the counterfactual test has been somewhat controversial. This is because it is said that the assumptions in the hypothetical scenario can be difficult to get right, at least in some cases. Further, it is said that applying those assumptions is, or can be, distinctly unrealistic. Opinions can differ sharply, as was indeed demonstrated by the 3:2 split on this very kind of issue in the Privy Council in *Carter Holt Harvey Building Products Group Ltd v Commerce Commission*.

[48] Nevertheless, these difficulties were articulated, and they were directly put to the Privy Council in the second case from this jurisdiction to go before their

Lordships. They were not deterred by them. Far from holding that resort to this technique is not appropriate, the Board said (at [60]):

> It is, as the Board said in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* at p 403, *both legitimate and necessary* when giving effect to s 36 to apply the counterfactual test to determine whether the defendant has used its position of dominance. (Emphasis added.)

[49] Given this pronouncement, in this Court Mr Farmer did not mount a direct attack on the usage of a counterfactual test. Indeed, he could hardly have done so in the face of the direct holding of the Privy Council. For in delivering the advice of the Board, Lord Hope of Craighead was quite well aware of the concern that had been expressed in this jurisdiction about the counterfactual test (at [50]): "[i]t is evident that the Courts below showed a marked lack of enthusiasm for what has come to be known as 'the counterfactual test'". But that did not deflect their Lordships from adhering to the appropriateness of the test.

[50] Further, Mr Hodder correctly reminded us that this Court in *R v Chilton* [2006] 2 NZLR 431 has held that, generally, it will remain bound by Privy Council decisions made in respect of appeals from New Zealand. He said this panel should not therefore entertain any kind of "end run" around these two decisions of their Lordships. Any change of approach should be made only by the Supreme Court of New Zealand.

[51] In fairness, that was not quite what Mr Farmer was submitting. He rightly acknowledged the difficulties for this Court, but advanced the proposition that the counterfactual test should not be the *sole* test of use of a dominant position. His (rhetorical) question was whether is it "always" necessary. Mr Farmer referred us to the observations of Gault J in *Port Nelson Ltd v Commerce Commission* (at [42] above), and the observations of this Court in *Telecom Corporation of New Zealand Ltd v Commerce Commission* (2001) 10 TCLR 182: that the question of "use" is still in a state of evolution, and that the question whether there has been a use of a dominant position "might seem a straightforward factual enquiry once the dominant position is established" (at [17]). He questioned whether the Privy Council had squarely intended that the counterfactual test was to be applied in every case.

[52] Mr Farmer relied heavily on the decision of the High Court of Australia in *Melway Publishing Pty Ltd v Robert Hicks Pty Ltd* (2001) 205 CLR 1. He referred in particular to the following passage in the judgment of Gleeson CJ, Gummow, Hayne and Callinan JJ (at [52]-[53]):

> To ask how a firm would behave if it lacked a substantial degree of power in a market, for the purpose of making a judgment as to whether it is taking advantage of its market power, involves a process of economic analysis which, *if it can be undertaken with sufficient cogency*, is consistent with the purpose of s 46. But the cogency of the analysis may depend upon the assumptions that are thought to be required by s 46.
>
> *In some cases, a process of inference, based upon economic analysis, may be unnecessary. Direct observation may lead to the correct conclusion.* Deane J thought that *Queensland Wire* was such a case.
>
> (emphasis added).

[53] Based upon this and other passages in *Melway*, Mr Farmer's essential proposition is that unlike the Privy Council, the High Court of Australia has not regarded the counterfactual as the *sole* test of use. He suggested that given its difficulties of application, and perhaps even inappropriateness in some cases, it is not always necessary to apply it. Courts can and should instead have regard to at least two other approaches: the direct observation approach suggested by Deane J in *Queensland Wire Industries Pty Ltd v Broken Hill Pty Co Ltd* (1989) 167 CLR 177, which was referred to with approval in *Melway*; and the "materially facilitated" approach which was referred to in *Melway* (at [51]). See also *Rural Press Ltd v Australian Competition and Consumer Commission* (2003) 216 CLR 53; *NT Power Generation Pty Ltd v Power and Water Authority* (2004) 219 CLR 90; and *Pacific National (ACT) Ltd v Queensland Rail* [2006] FCA 91.

[54] An intermediate appellate court is always in a difficult position when faced with this sort of issue. On the one hand, there is the high desirability of the orderly development of the law and the certainty engendered by a final appellate court determination. And this is an instance in which the then final appellate authority for New Zealand has specifically said that it had received, considered, and rejected the concerns which had been raised about the use of a counterfactual test. On the other hand, it would be particularly unfortunate in an Australasian context, with the strictures to harmonise commercial law under the present CER regime, if Australian

and New Zealand law were to be on different footings on this important issue. But if a change is to be made, it would seem to be appropriate that it be undertaken by the Supreme Court of New Zealand, if this is an appropriate case in which to undertake such an exercise.

[55] As it transpires, and not for reasons of avoidance of the issue, things do not come to such a stark choice in this particular case. For it is hard to see why in any exercise such as the present a court would not at least ask, in relatively straightforward terms: "What would have happened if the impugned firm was not dominant in the particular market?" The answer to that question must, on any view of the case, carry very real weight, even if it is not dispositive.

The relevant markets

[56] We turn now to the cluster of appeal points around the definition of the relevant markets for this case. As we have already noted the issue here is really one as to the particular product which was in issue.

[57] The High Court had the benefit of evidence from Dr Bamberger, and Professors Evans and Hausman for Telecom on this issue. The Commission's expert, Dr Bamberger, preferred a market for originating and terminating wholesale network access, as did Professor Evans. Professor Hausman however thought the relevant market should be confined to terminating access. The High Court agreed with Professor Hausman that his "narrower definition is better suited to a consideration of dominance. At the wholesale level, the 0867 service related only to the termination of local calls. That is the relevant field of rivalry" (at [24]).

[58] Neither party is satisfied with the High Court ruling. Telecom seeks to support the decision appealed against on a further ground, namely that Telecom did not have (and the Commission failed to prove it had) a dominant position in the market for fixed line retail services to retail customers.

[59] The Commission submits that the relevant market is for interconnection to a fixed line network encompassing *both* originating and terminating access. This was

the view of two of the three experts who gave evidence. It is said that both these "services" are interlinked in such a way that really they are the same service. As Mr Farmer put it, originating and terminating access are both access to that part of a carrier's access network between the customer's premises and the service delivery point (SDP) where the call is connected to the rival carrier's core network. Terminating and originating access are therefore substitutable for each other, at least on the supply side.

[60] The Commission's criticism of the High Court decision is that the Court has assumed that local access is the only service that requires terminating access alone. It says this is incorrect. Under the interconnection agreements (ICAs) the services provided are "local interconnection services" and "toll interconnection services". At least in the case of toll interconnection, the ICAs envisage that a carrier may purchase originating and terminating access, or originating access only, or terminating access only. And it is said there are a number of indicators that Telecom regarded the relevant market as a combined one of "interconnection". Toll interconnection services which encompassed originating and/or terminating access and local interconnection services (which encompassed terminating access only) were negotiated and agreed in the one interconnection agreement. There were not separate commercial agreements. It is further said the relevant market should not be defined by reference to the scope of operation of the 0867 scheme, which did not apply to business calls, whereas neither toll nor local interconnection services were so limited.

[61] For Telecom, Mr Hodder said that in reliance on Professor Hausman, the only expert who turned his mind directly to the point, the High Court accepted that the market is more usefully defined by termination only. Secondly, Mr Hodder said it is circular to define a market from commercial arrangements for services in a multitude of markets, and still less illuminating to do so from just one firm's commercial arrangements. Rather, he suggested, the High Court had correctly focused on the economic activity at issue, the provision of wholesale network terminating access.

[62] This is a general appeal. To succeed, there is an obligation on a party to satisfy us that a judgment or a particular part of it is "wrong". We are not so satisfied on this point. The focus of this particular inquiry is on a particular kind of economic activity. The argument is not as to an extended field of telecommunications activity but, in this instance, to the wholesale network terminating access market.

Dominance

[63] Whether Telecom had a dominant position in the national wholesale network terminating access market was not distinctly contested in the High Court. Dr Bamberger gave affirmative evidence that Telecom was dominant; Professor Evans refrained from stating an opinion; Professor Hausman said that Telecom may have had substantial market power, but asserted that Clear had earned "supra-normal profits" from what it earned for termination on its network.

[64] The High Court accepted that in 1996, when the ICA with Clear was concluded, Telecom was "clearly dominant" in the wholesale market, for the reasons which Dr Bamberger had given. These included the terms of the 1996 ICA itself. This enabled Telecom to charge a substantially higher price for local call terminating access than Clear. This must indicate that Telecom had market power. Then there was the fact that Telecom's prices for wholesale network access was substantially above its costs and its ability to price discriminate in the market. Further, because of its ownership of the local loop – and no firm could replicate that enterprise – any firm offering telecommunication services in New Zealand would have had no reasonable alternative to acquiring wholesale network access services from Telecom. There was no dispute about this finding, up until 1999.

[65] The High Court did however – it seems on its own initiative – hold that by 1999 Telecom was no longer dominant. The Court said that dominance had been negated by changes in market conditions in the very form of competition from Clear.

[66] It appears that the Court's conclusion on this point rested on these factors:

- Clear had successfully established its own networks in the central business districts of the three largest cities;

- In these areas Clear was competing on equal terms with Telecom for business customers, particularly ISPs;

- Clear was generating supra-normal profits by virtue of the terminating access provided to ISPs on its network;

- Clear's established network and a continuing growth in internet traffic meant that when the ICA came to be renegotiated, Telecom would be required to offer cost based terminating access as in fact occurred;

- Clear had become an effective competitor in the market for terminating access whose conduct demonstrably operated as a significant constraint on Telecom.

[67] Mr Hodder submitted that the High Court had come to a correct factual determination after a close regard to the evidence in the trial before it. He relied in particular upon four factors:

- The ICAs asymmetric prices are uninformative of Telecom's market power because Telecom had become a net player;

- Even very limited access networks could (and did) host ISPs which did not require any originating access service from Telecom;

- Clear was very successful in competing for ISPs business;

- Clear's countervailing power was graphically illustrated by Telecom's commercial position, in that Telecom found itself paying out much more in termination fees than it received (which is one of the very reasons Telecom introduced the 0867 service).

[68] We agree with the High Court that in 1996 Telecom was dominant in the market for terminating local calls. We have however very distinct reservations about the High Court's conclusion that this dominance had been lost by 1999.

[69] The focus must be on the extent to which Clear (and other providers) were able to constrain economically the market power of Telecom.

[70] The primary factors which point to a diminution of Telecom's market power are that:

- The disparity in terminating charges, provided for in the 1996 ICA, were to diminish over time.

- When the ICA came to be renegotiated terminating charges were based only on cost.

- Clear, operating within the scope of the ICA, had been able to develop some CBD networks and had attracted a number of business customers including ISPs.

[71] On our assessment of the evidence and the realities of the situation at the time, these factors do not exemplify Clear's economic power (and an associated reduction in Telecom's market power) but rather Telecom's fear of regulation. In the aftermath of the 1995 Privy Council decision, the government of the day made it clear that an attempt by Telecom to insist on the Baumol-Willig Rule would result in regulation. (For a description of the Baumol-Willig Rule, see *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* at 395-397). That was the setting in which the 1996 ICA was negotiated. Although it is not entirely clear on the evidence how an ICA configured in accordance with the Baumol-Willig Rule would have compared with the 1996 ICA, it is a fair inference that the 1996 ICA (which in effect permitted Clear to share some of Telecom's monopoly rents) was more favourable to Clear than the Privy Council would have required.

[72] By the time the new ICA came to be negotiated after the events which are at the heart of this litigation, there had been an election, a new government and further proposals for regulation, which eventually were enacted in 2001.

[73] In this context, we have no difficulty in accepting that there were significant constraints on Telecom, but these constraints were primarily associated with the threat of regulation. We do not see such constraints as diminishing the market power of Telecom. And as the 0867 dispute itself shows, where Telecom considered that the risk of regulation was low, it was able to deploy market power very effectively.

[74] For those reasons, we are satisfied Telecom continued to be relevantly dominant. Our differing from the High Court in this respect does not affect the outcome of this appeal, given the other aspects of it, to which we now turn.

Use and the counterfactual

Introduction

[75] To recapitulate briefly, there is not a breach of s 36 unless it can be shown that a defendant used its dominant position, in the sense that there is a causal link between the defendant's dominant position and the conduct which is alleged against it. It was this that led the Privy Council to hold that it is "appropriate and necessary" that there be a counterfactual test for determining whether there is a causal nexus between the dominant position and the impugned conduct. That test is simply whether a hypothetical firm that was not in a dominant position but was otherwise in the same circumstances would have acted as the dominant firm did. "Would" in this context means "could rationally": *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* at [29].

[76] In the present case the High Court held that its analysis lead "inexorably to the conclusion that a non-dominant firm in Telecom's position in a competitive market would have been able to introduce the 0867 service in order to deal with the termination fee and network capacity issues which concerned Telecom" (at [89]).

The potential difficulties in constructing a counterfactual

[77] Mr Farmer contended that counterfactual analysis in this case was always going to be inherently problematic. He said this was foreshadowed by this Court in 2001 in *Telecom Corporation of New Zealand Ltd v Commerce Commission* when it stated (at [24]): "we have difficulty in postulating Telecom confronted by the internet problem (which seems to rest on its high proportion of customers) yet not dominant in the market". This of course formed a plank in Mr Farmer's argument that being confined to a counterfactual driven "solution" to the problem is unrealistic and does not properly serve the ends of the overall s 36 inquiry. Whether this is so depends upon the counterfactual actually recognised by the Court, to which we will shortly turn, but first there is a process point which is worth mentioning.

The process of constructing counterfactuals

[78] What happened in this case is that three very well qualified expert witnesses were called upon to assist the Court. They observed all the appropriate requirements for expert witnesses, which are designed to avoid partisanship. At one point a lengthy "hot tub" session was held. This is an exchange of views between the various experts with them able to speak directly to each other (of course, under court supervision) in an endeavour to clarify and articulate the various points of concern which have arisen between them. The process has been found to be sufficiently beneficial to be resorted to from time to time in competition law cases. It does however have some downsides, one of which bears mention here.

[79] Plainly, if the counterfactual is to play a significant part, it would be better if counsel knew precisely what counterfactual the Court is proposing to adopt *before* their final arguments are made. There would be much to be said, as a matter of case management, if, after the economic evidence (including any hot tub evidence) is in, the Court could be addressed on what counterfactual should be adopted, and if the Court could then issue a minute or memorandum as to what counterfactual it does propose to adopt. Counsel could then be heard on the application or consequences of that particular counterfactual. Otherwise, final addresses are addressing a somewhat

shadowy target. We do not intend to lay down any rule, let alone a prescriptive rule, on this point. Our suggestion is one which trial judges may find helpful in the context of a given case. If it had been followed in this instance, it may have avoided some of the difficulties in submissions over what was to be assumed.

The Court's counterfactual

[80] In the result, in this case the High Court came to this conclusion on the counterfactual:

> [77] The first step in the counterfactual analysis is to identify the essential characteristics of a competitive market. There was general agreement that they would include:
>
> - At least three firms operating in the relevant market – Telecom (Company X), Clear (Company Y) and at least one other. None would be dominant. No firm will be earning supra-normal profits.
> - Like Telecom and Clear, Companies X and Y would be parties to an ICA with the essential features of the 1996 ICA.
> - Like Telecom, Company X would be bound by the KSO.
> - Both Company X and Company Y, like Telecom and Clear, would have their own ISP and have other ISPs on their network. It must also be assumed that, as Telecom did with Ihug, Company X was able to come to an agreement with an ISP which gave it no less than 75% in aggregate of the ISPs terminating traffic.
> - Finally, the counterfactual must assume that Company Y has the small number of residential customers which Clear had relative to its ISP terminating traffic, so as to replicate the net imbalance of termination fees which Telecom experienced.

[81] There are two broad questions arising with respect to this counterfactual, as so constructed. First, is it the appropriate counterfactual? And secondly, if it is, what are the consequences which flow from that in relation to the s 36 inquiry?

Was this an appropriate counterfactual?

[82] The High Court had expert evidence which identified the characteristics of a workably competitive market. It said these would have to include multiple non-

dominant firms (X = non-dominant Telecom; Y = Clear; and W = another firm). Each would have to be hosting proprietary and other ISPs on their networks. X and Y would be party to the 1996 ICA. X would be bound by the KSO which would necessarily mean disproportionately many residential customers to ISPs on its networks, compared to Y or W.

[83] Counsel for Telecom correctly pointed out that by the end of the expert evidence all three expert witnesses were prepared to subscribe to the formulation ultimately adopted by the Court.

[84] Counsel for the Commission was critical of this formulation in this Court largely (though not exclusively) because he argues that the counterfactual as thus constructed effectively defines away the problem. The Privy Council had decreed that there be the same workable competitive market, save that there would be a non-dominant Telecom. But as the Commission argues, the asymmetric and above cost termination payment regime in the 1996 ICA, Telecom's KSO obligations, and the disproportionate number of residential customers on Telecom's network compared with its competitors had led to a huge traffic imbalance. But all of these circumstances are said to be attributes of Telecom's *actual* dominant position, and if they are attributed to X (a non-dominant Telecom) then that company also has market power.

[85] Mr Farmer's argument is, at heart, that by definition what was constructed cannot be a competitive market. It assumes that no firm would be earning supra-normal profits, but also that X and Y would be parties to an ICA with the essential features of the 1996 ICA. But, he said, if the first characteristic exists, that defines out the supra-normal profits that are a feature of the second factor. The market as so constructed also enshrines a playing field that is simply not level.

[86] There are several difficulties with Mr Farmer's argument. First, as a matter of law, the test we must apply is as propounded by the Privy Council: it is to be the *same* market, less a dominant X. Secondly, all the expert evidence accepted the formulation of the relevant workably competitive market stated by the High Court. Thirdly, in economic terms Mr Farmer must be arguing for a "pure" competitive

market. But there will almost always be some unusual features or quirks of a market. And those present in this case are very unusual.

The consequences of the counterfactual

[87] The sensible starting point is to ask what benefits the 0867 solution was seen as securing for a non-dominant Telecom in the postulated market. They were:

- To bring to an end the high and increasing outflow of charges for terminating access to ISPs on Clear's network;
- To deny Clear the ability to attract ISPs to its network by sharing terminating revenue;
- To provide an incentive for ISPs to move from Clear's network to Telecom's network if Clear refused (as it did in fact) to enter into a new agreement with Telecom to obtain the 0867 number range;
- To save Telecom the capital costs of expanding its network to meet the growth in internet traffic usage for residential customers calling ISPs on Clear's network.

[88] The question is then whether it would have been profitable for a firm in a non-dominant Telecom's position in that market to introduce the 0867 service. For if it would not have been, the logical conclusion is that it could only have done so in 1999 by virtue of the dominance it enjoyed in that market.

[89] This facet necessarily, at least in this counterfactual, introduced a considerable volume of economic "evidence", much of it really supposition. We first indicate the conclusion arrived at by the High Court before turning to Mr Farmer's criticisms of that conclusion.

[90] The High Court began by noting that against the benefits available to company X had to be set the potential costs of introducing the 0867 service.

Prominent amongst these would be that company X would face the prospect of losing residential customers on its network who, rather than switch ISPs to avoid the per minute charge under the 0867 package, chose to remain with their ISP but to switch networks. This turned on the number of customers who might switch networks and the net cost lost per customer. The High Court took the view that the number of customers who would choose to switch networks "appears to be limited". The High Court considered that the "net loss in residential customers is accordingly likely to be small; a net gain could even result" (at [83]). But even if company X lost customers, the Court took the view that "it does not appear that there would be a cost to it" (at [84]). Nor would the net effect differ if, instead of migrating from company X to company Y, it is postulated that company X's residential customers move to another carrier, regardless of whether or not that carrier had an ICA with company Y, and the terms of such an ICA. If the ICA involved asymmetrical termination charges, company Y would continue to receive termination revenue. And it would be illogical for another carrier to seek business on the very terms that had prompted company X to introduce the 0867 service in the first place.

[91] There was some argument about whether economies of scale and scope might arise and whether that would "outweigh" the benefits of introducing 0867 in a competitive market. The High Court thought that not to be of any distinct moment.

[92] There was also consideration of the effect of the KSO. Assuming the KSO was to apply only to company X, company Y and other carriers would not be required to maintain a free calling option. They might perhaps charge residential customers in order to generate revenue from termination payments but in such a scenario there would be a reduced incentive for residential customers to move from company X.

[93] Mr Farmer acknowledged that in this consideration the Court's "key finding" was that although company X would face the prospect of migration of residential customers on its network, there was effectively no cost to company X in losing these customers, since they were causing it to bleed termination charges to company Y.

[94] Mr Farmer submitted that the High Court findings were wrong for these reasons. Company X would lose the opportunity to earn other collateral revenues such as toll calls, mobile services, mobile interconnections, and so on. He also questioned the "lost revenue" argument on the basis that when a firm with substantial fixed costs loses customers, the revenues associated with the lost customers will generally outpace the cost savings from no longer serving those customers. Associated with this could well be "stranded" assets which cannot readily be redeployed or sold (they are sunk costs). Further, company X would in any event have been earning revenue well above costs on toll interconnection and local interconnection charges for calls to those customers from other networks.

[95] As to the argument that there was no evidence or evidential basis to show that the economies of scale referred to by Dr Bamberger might arise and that these economies would outweigh the benefits of introducing the 0867 scheme, Mr Farmer submitted that the Commission should not be expected to call evidence in this sort of setting which is merely a hypothetical construct and that appropriate assumptions may be made. Some assumptions had been made in favour of Telecom.

[96] More generally, Mr Farmer suggested that the telecommunications industry is dynamic with rapidly developing technology and that in a general way company X would want to keep and expand if possible the number of customers on its network to whom it could in turn sell new innovative technologies, such as ADSL. He also pointed to some internal evidence in Telecom's documents that Telecom generally did not want to lose customers. This led him to submit, overall, that in a competitive retail market Telecom could not have profitably introduced 0867 and that there was a real likelihood that it would have incurred a significant cost in the form of loss of residential retail customers.

[97] For Telecom, it was emphasised that, generally speaking, if there was a competitive market in which the parties were getting normal rates of return, X would have no interest in retaining those customers. The evidence of Dr Bamberger, which was relied upon heavily by the Commission, was no more than "speculative" as to the availability and comparative size of scale economies. Further, relying upon the evidence of Professor Hausman, telecommunication services cannot be treated as a

bundle: consumers could, to take only one instance, buy local access from X and toll calls from Y. Cable service could come from another party. It was said that the Commission could not simply assert that the fact that scale economies might exist (if in fact they did) provides no foundation for a comparative analysis of the type the Commission was belatedly seeking to have the Court make. Further, it could not be said, on the evidence in court, that the advent of new technologies would justify Telecom incurring increasing losses on internet customers in the hope that the losses would be recouped in the future.

[98] In our view, it is vital to recall the basic question the High Court was having to address here. The issue is not what company X “would” or “should” have done. The issue is what it “could” rationally have done in this particular competitive market. The answer to that is not the expression of precise economic modelling or the production of a mathematical proof. Company X had to consider a number of factors, only one of which was the effect of a potential loss of customers. There were powerful reasons going to the avoidance of termination charges and the overcoming of network congestion to be considered, along with the implications of any loss of customer base which might be incurred by the introduction of the 0867 scheme. To argue, as the Commission has done, that, on any rational consideration, the potential loss of customers would necessarily and inevitably have outweighed the other matters at issue is a very long bow indeed. We would have thought that it would have to be demonstrated that there was highly likely to be a very significant loss of customers for that factor to become ascendant. That has not been so demonstrated.

[99] As we have noted, on an appeal of this character it is for the appellant to demonstrate that the High Court was wrong. On the law we have to apply, the evidence which was in court, and such inferences as could reasonably have been drawn from it, we are not so satisfied. This appeal point too is dismissed. It follows that the appeal as a whole must be dismissed.

Some concluding comments

[100] We do however make these comments. This case exposes the realities of the difficulty of counterfactual analysis and that it is not always of utility in the context of a case such as the present. The reality of the case is that it is about terminating charges which are markedly above cost and the willingness of Telecom, under threat of regulation, to share its monopoly rents with Clear. Any realistic counterfactual must take monopoly rents as a given. It is difficult to see how there can be any plausible counterfactual about the distribution of monopoly rents where non-dominance has to be assumed: in the absence of dominance there can be no monopoly rents.

Conclusion

[101] The appeal is dismissed.

[102] Costs are reserved. We do however indicate that Telecom must have its costs in this Court. If counsel are unable to settle those costs, Telecom should file submissions as to quantum within 21 days of this judgment; the Commission will then have 21 days to file its submissions in reply. This Court will then resolve that issue, on the papers.

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