0867 dials-up competition law changes?

What is the 0867 litigation all about, and how did Telecom win – under section 36 of the *Commerce Act* 1986 – in *Commerce Commission v Telecom*? **Michael Wigley** explains

On 19 May, the Commerce Commission decided to appeal the High Court decision in *Commerce Commission v Telecom Corporation of New Zealand & Anor* (18 April 2008, High Court, Auckland CIV 2000-485-673, Justice Rodney Hansen and MC Copeland), saying: "…the case raises crucial legal issues relating to the application of section 36 of the *Commerce Act* [1986]. These issues are not only relevant for this case, but also for future section 36 cases. Clarification of the legal issues to be raised on appeal will benefit the development of competition law generally."

So, what's the case about and what's up for review on appeal?

0867 in a nutshell

In 1999, Telecom introduced a big change to billing in relation to other telcos, ISPs, and residential dial-up Internet. This had many of Telecom's competitors up in arms.

First, some background. In 1994, Telecom won a major *Commerce Act* victory against Clear in the Privy Council: *Telecom Corporation of New Zealand v Clear Communications Ltd* [1995] 1 NZLR 385. It was a defining moment for New Zealand telecommunications and for New Zealand competition law. At stake was what Telecom could charge Clear to interconnect with Telecom's network so that Clear's customers could communicate with Telecom's, and vice versa. In a controversial decision, the Privy Council allowed Telecom to bill Clear a lot more than Clear hoped for, and endorsed the counterfactual test outlined below.

Telecom's win led to an interconnection agreement between Clear and Telecom in 1996. One aspect of the agreement was the payment of termination charges. Say a residential customer, A, on one network made a call to B on the other network. This could be a call from a Telecom customer to a Clear customer or vice versa. The network used by A had to pay a per-minute termination charge to the network used by B. The Privy Council win meant that the termination charge paid by Clear to Telecom was higher than the other way around. Most voice calls terminated on Telecom's much larger network, so Clear was making considerable net payments to Telecom.

This win was terrific for Telecom… well, at least at the beginning.

Then Telecom scored an own goal. Residential dial-up Internet use expanded way beyond Telecom's and Clear's expectations. Quickly, residential dial-up Internet became a major use of Telecom's local access network.

Dial-up Internet has different characteristics from voice traffic. In particular:

- Voice traffic has largely balanced characteristics. Internet traffic is totally different as calls go in only one direction. The residential customer originates (ie 'dials up') all calls with the ISP and nothing is originated back the other way. If the ISP is on the Clear network and its residential dial-up customer is on Telecom's network, Telecom pays the per-minute termination charge to Clear. There were far more residential customers on Telecom's network. If Clear had a successful ISP on its network, it could pull in large termination charges from Telecom based on Telecom's residential local access customers using a Clear ISP.
- Internet calls, typically, are a lot longer in duration than voice calls. With per minute charges, the payments by Telecom could become even larger.

Clear and other ISPs took advantage of the opportunity. They were able to keep their ISP charges to customers low or even free, with, in effect, Clear and the ISPs sharing the termination charge revenue paid by Telecom. The Court said that this created "perverse incentives".

Under the Kiwi Share agreement with the Government, Telecom had to supply to residential customers free and unlimited phone line access for a fixed monthly fee. This both caused and added to the problem faced by Telecom.

Telecom sought solutions to its problems caused by these developments. Ultimately, it introduced a solution which encouraged residential customers (and ISPs based on the Clear network) to migrate to using a dial-up number with the 0867 prefix. 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, lost its right to claim the termination fees (and therefore lost the arbitrage opportunities).

Residential customers could continue to access their ISPs using dial-up numbers other than those with an 0867 prefix. However, if they did this, they would have to pay two cents a minute (unless their ISP was Xtra) beyond 10 hours of Internet use each month. This meant:

- in effect, the ISPs were driven towards the 0867 solution; and
- the 0867 calls were outside the Kiwi Share. Legal advice to the Government at the time said that charges for these dial-up calls was not permitted under the Kiwi Share. However, the Minister controversially allowed the change to go ahead, with some conditions.

It was claimed at the time that Telecom introduced 0867 to plug the outflow of termination charge payments and deal to the competitors. It was said that this was a misuse of Telecom's dominant position, under section 36 of the *Commerce Act*.

Telecom had choices as to how it could proceed, including choices that did not erode – so much – the termination payments to Clear. But Telecom elected an option (0867) which took away the large payments it was making to Clear.

Why did Telecom win?

Having got to the point where the Court decided Telecom was dominant in a market, there are two further steps before a firm has breached section 36 of the *Commerce Act*: the "use" and the "purpose" steps (section 36 was amended in 2001, and follows the same approach, based on significant market power, not dominant position).

The two steps are:

- **Use:** First it has to be shown that the dominant firm *used* its dominance to, among other things, deter any competitor from engaging in competitive conduct.
- **Purpose:** If the firm has used its position in that way, there is still no breach unless it used its position for the *purpose* of, among other things, deterring any competitor from engaging in competitive conduct.

Telecom won on both of the two grounds. To succeed outright, it only had to win on one.

The first step: "use" and the counterfactual test

The Court in the 0867 case had to apply the controversial counterfactual test, which had been endorsed by the Privy Council in *Telecom v Clear* (and again in *Carter Holt Harvey Building Products Group Ltd v Commerce Commission* [2006] 1 NZLR 145). Broadly speaking, the Court works on a scenario (a counterfactual) which assumes that the market is competitive. Oversimplifying, could the firm that is being sued have acted in the same way even if there were competitive market pressures? If yes, the firm is not using its dominant position.

After applying that test, the Court concluded that Telecom, in that assumed competitive market, would have been able to introduce the 0867 service. Therefore, it had not breached the *Commerce Act*.

Stated in this way, the counterfactual test has alluring simplicity and logic.

However, the counterfactual test

has come under attack, including:

- Contrary to the Privy Council position, there is a marked dislike of the test in our New Zealand-located Courts. This may underlie the Commission's appeal, now that the Supreme Court has replaced the Privy Council.
- Getting the assumptions in the hypothetical scenario right, and applying those assumptions, is difficult and, some say, unrealistic. This is demonstrated by the Privy Council's 3:2 split on this point in the *Carter Holt Harvey* case.

The counterfactual approach is not the only solution to the difficult delineation between 'bad' misuse of market power and 'good' competitive rivalry. For example, the European Union (EU), by a different combination of underlying law and decisions, puts "special responsibilities" on dominant firms. Therefore, it does not use the counterfactual test in this way. As Bellamy and Child have said of the EU position in their text, *European Community Law of Competition* (6th edition, Oxford University Press, 2008): "[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."

The second step: purpose

Telecom won on the second step as well. Assuming Telecom *used* its dominant position, it did not do so for anti-competitive *purposes*. Having as a purpose improving its position as against its competitors does not in itself mean that Telecom is in breach.

There's a key reason underpinning the judgment. Contrary to the views of many at the time, there was, said the Court, "a massively increased loading on Telecom's network" which Telecom had to solve.

It was also clear that Telecom was aiming to stem the adverse and growing imbalance in fees payable by Telecom to Clear.

These two drivers (network congestion and reducing termination charges payable to Clear and others) were intertwined. Sort out the latter and the former gets sorted out too, as congestion reduces because of reduced traffic.

However, in its public statements and in dealings with the Government, Telecom focused on the advantages of 0867 for network management. The key manager at Telecom said it chose to do this as this was a more palatable or sellable public message. That in itself doesn't mean that Telecom is acting with anti-competitive purpose.

One of the things that emerges from the case is that where a firm such as Telecom has a number of choices to solve a particular problem, and elects a choice which has more negative impact upon its competitors, it does not follow that it is acting wrongly under section 36.

The court also decided that, by removing what it said were perverse incentives, the outcome was in fact *pro*-competitive, at least in the short term. When expert economists can separately conclude that conduct is at different ends of the spectrum (anti-competitive at one end and pro-competitive at the other), it shows just how challenging this area is.

Underlying the Court's conclusion on purpose is another controversial Privy Council conclusion: a dominant firm is entitled like everyone else to compete with its competitors. To stop this would be to stifle competition and to hold an umbrella over inefficient competitors. Some commentators think that this begs questions and much controversy. For example, it's said that powerful firms are not the same as their small firm competitors. Their economic strength renders them especially likely to damage the competitive process, so they have a "special responsibility" (Adhar, 'Escaping New Zealand's monopolisation quagmire' (2006) 34 ABLR 260).

Conclusion

Drawing the line between 'good' competition and 'bad' monopolisation is difficult, and our appeal courts will grapple with these issues afresh, now that the Supreme Court has replaced the Privy Council.

Michael Wigley is the principal of Wigley & Company, barristers and solicitors. He can be contacted on (04) 499 1841 or michael.wigley@wigleylaw.com.