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The "Ladder of Investment" – Is it wobbly?

The policy changes in New Zealand rely on the seductive concept of a "ladder of investment" which depends upon an omniscient regulator.

The ladder of investment provides regulators with a blue-print for nudging industry structures towards facilities-based competition with less regulation. The NZ Cabinet Paper on telecoms policy [1] says "*Commencing at lower rungs of the ladder with basic resale and intermediate wholesale of services while building a customer base, this concept envisages movement via LLU* (local loop unbundling) *to eventual investment in alternative network infrastructure"* (Para 99).

Too tricky?

Policy makers do not want inefficient investment in, say, duplicating the copper CAN. So, according to Martin Cave, professor at Warwick Business School at the University of Warwick in the UK, the first trick is to guess what assets are replicable *"recognising the danger that the regulator could be making a self-fulfilling prophecy"*. [2]

The "non-replicable" or natural monopoly infrastructure remains subject to access regulation. Primus argues that Telstra's proposed FTTN *"is not a new network but a modernisation of its existing copper network"* [3]. This is a moot point; it is still a discretionary $3 billion investment which will not be undertaken *for "a commercial return commensurate with a regulated monopoly facility"*.

The second trick is to second-guess what entrant investment might be triggered by regulatory intervention and over what time frame which Cave says *"will require careful judgement"*. Right.

This then leads to either setting a sunset clause for the withdrawal of access obligations or raising access prices relative to costs over time. In the former case, regulators must make credible commitments on the termination of entrant access holidays. In the latter case, Cave and others suggest that the access price rises to the option value.

Option value

The "eventual" migration to investment in alternative infrastructure will only occur if the continuing "buy" cost is not too far from the "build cost". Cave argues that the option to continue buying in conditions of uncertainty and sunk costs has a value that has to be priced into the access price or there will be bias against entrant investment.

Ofcom does not like the idea of pricing access on the value to access-seekers but it is definitely interested in looking at option pricing access to major new investments like BT's NGN. [4] The same should apply to Telstra's FTTN.

Note also that when the "buy" cost is regulated to the most efficient "build" cost by TSLRIC, there is no incentive to climb the ladder. Cave cites the US experience as an example of how *"if comprehensive access products are too cheap, competitive investment will not materialise. The lack of such investment may then be taken to justify the access policy, completing the circular argument."* [2]

Adding rungs at the top

The focus of regulation to-date has been to facilitate access to "legacy" networks. This meant adding rungs to the middle of the ladder such as line-sharing and LLU to encourage migration up the ladder. But a study of unbundling in five countries found *"no evidence in support"* of the ladder of investment (aka stepping stone) thesis [5].

Also, the framework has to be revised. There is a trade-off or balance between achieving short-term welfare gains from access regulation and the promotion of investment in new and alternative networks. This balance has changed. The policy focus now is on adding a new rung to the top of the ladder; specifically FTTN. This means that the regulatory balance now has to shift to stimulating risk-taking and investment in broadband access and NGNs.

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[1] Available at http://www.beehive.govt.nz/ViewDocument.aspx?DocumentID=25636

[2] Martin Cave "Encouraging infrastructure competition via the ladder of investment" in Telecommunications Policy, Vol.30, Issues 3-4, April/May 2006

[3] Ian Slattery "A new monopoly is not the answer" in Exchange, 24 March 2006

[4] Ofcom "Ofcom's approach to risk in the assessment of the cost of capital", August 2005

[5] Jerry Hausman and Gregory Sidak "Did mandatory unbundling achieve its purpose? Empirical evidence from five countries", MIT Working Paper 04-40, November 2004 http://ssrn.com/abstract=623221