Privy Council Appeal No. 21 of 1994

Telecom Corporation of New Zealand Limited and Others — *Appellants*

v.

Clear Communications Limited — *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 19TH OCTOBER 1994

Present at the hearing:-

LORD KEITH OF KINKEL
LORD JAUNCEY OF TULLICHETTLE
LORD BROWNE-WILKINSON
LORD LLOYD OF BERWICK
LORD NOLAN

*[Delivered by **Lord Browne-Wilkinson**]*

Until 1987 the public telecommunication system in New Zealand was a state monopoly conducted by the Post Office. In 1987 that system was acquired by the appellant, Telecom Corporation of New Zealand Limited ("Telecom"), then a State Owned Enterprise. It continued to enjoy a virtual monopoly. On 1st April 1989 all telecommunication markets in New Zealand were opened to competition. In September 1990 the Government sold all its shares in Telecom, save one ("the Kiwi Share") to privately owned interests. The respondent, Clear Communications Limited ("Clear"), commenced negotiations to enter into competition with Telecom in two sectors of the telecommunication system, namely toll calls and local telephone services for business customers in the Central Business Districts ("CBD") of the larger cities, Auckland, Wellington and Christchurch.

It is a fundamental requirement of anyone offering telecommunication services in any part of the system that its customers should be connected to all other telephone users in New Zealand. No one will buy a telephone service which permits him to send and receive calls to and from only some telephones. This is called the requirement of

ubiquity. It was therefore necessary for Clear to arrange that its network should be connected to the Public Service Telecommunications Network ("PSTN") owned by Telecom.

So far as has been discovered, in all other countries where private competition has been introduced into a public telephone system (e.g. the U.S.A., Australia and the United Kingdom) would-be competitors have been given statutory rights to interconnect with the public system, the terms on which such rights are to be granted being settled in default of agreement by a statutory body. New Zealand has taken a different course. Competitors have no statutory right to be connected to Telecom's PSTN; no guidance has been given as to the terms on which such interconnection is to be granted; no independent body has been established to resolve the position if it should prove impossible for the parties to reach agreement. The decision was deliberately taken to leave the matter to market forces, at least in the first instance, subject only to the general prohibition on the improper use of a dominant position in a market contained in section 36 of the Commerce Act 1986. That section provides:-

> "36.(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
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> (b) Preventing or deterring any person from engaging in competitive conduct in that or in any other market; or
>
> (c) Eliminating any person from that or any other market."

Agreement has been reached between Telecom and Clear as to the terms for the interconnection of the Clear toll by-pass network to the PSTN. Although Telecom has throughout accepted that Clear's proposed local business services in CBD's should be connected to Telecom's PSTN, despite prolonged negotiations it has not proved possible for the parties to agree the terms of such interconnection. This is not surprising since, in the absence of any guidance, there is room for fundamental disagreement as to the principles applicable when a party which owns a national telecommunications network is required to sell access to such network to a party who is not only a customer but also a competitor. Telecom will not be quitting the limited area of the market which Clear wishes to enter (i.e. business users in the three CBDs) but will remain in direct competition with Clear for the custom of such business users. In the absence of guidance as to the principles applicable the parties were, as the High Court said, "negotiating in a fog". It is a regrettable fact that the decision of this appeal will only decide whether, in the past, Telecom has abused its dominant market position. It will not decide whether Clear's past stance in negotiations was reasonable, let alone fix the terms for interconnection.

Before turning to the history of the matter it is necessary to say a word about the background.

The PSTN.

The PSTN is connected to 93% of residential houses in New Zealand and to virtually all businesses. The detailed technology of the system is complicated and is fully explained in the judgment of the High Court. For present purposes it is enough to explain that a customer making a call does so through a twin-wire connection to the local exchange. This connection is called the "local loop". Thence, if the call is made to a number in the same local calling area it is connected through the local exchange system. If the call is made to a different local area the call is transmitted through Telecom's trunk system and the local loop in the local calling area of the receiver of the call. After the introduction by Clear of its competing toll by-pass system, when a trunk call is made by a Clear customer to someone in another local calling area, the link between the two local calling areas is provided by Clear, but both sender and receiver need to be linked locally to the Telecom system.

The technical aspects of introducing a Clear local service.

Under Clear's proposal, Clear will have its own exchanges in the selected CBDs. Those exchanges use the Centrex system which Clear calls "Gateway". Clear customers will be linked to Clear's exchange by a Clear system separate from that of Telecom i.e. Clear will provide its own local loop. However, in order to satisfy the requirement of ubiquity, the Clear system needs to interconnect with Telecom's PSTN so that Clear's customers can both make and receive calls from non-Clear customers. In due course the requirements of ubiquity will also force Telecom to obtain access to the Clear network, since once there are Clear customers who have no line to the Telecom local exchange, access to and from such Clear customers will only be obtainable through the Clear network.

The charging system.

Historically there have been two forms of charge made by Telecom and its predecessors to its customers: a rental charge and a traffic charge. The rental charge is payable for access to the system, the traffic charge for use of the system. Users are divided into two categories, business and non-business (or residential) users. Business customers pay a rental charge per line of $725 (approximately $60 per month): residential customers pay $29.62 per month. All toll calls (whether by residential or business customers) give rise to a traffic charge, the amount of the charge depending on the time and distance of the call. Local calls are free of any traffic charge to

residential customers; business users pay 3.55 cents per minute during peak hours and 0.44 cents per minute at off-peak times.

The Articles of Association of Telecom provide for what is called "The Kiwi Share" which is held by the Minister of Finance on behalf of the Crown. Under the Articles, unless the Kiwi shareholder agrees otherwise, Telecom is bound to provide "an ordinary residential telephone service" in accordance with the principles set out in Article 11.4.2 which reads:-

> "11.4.2. The principles relating to the provision of telephone services ... are as follows:
>
> > 11.4.2.1 Local Call Charging - A local free-calling option will be maintained for all residential customers. Telecom may, however, develop optional tariff packages which entail local call charges for those who elect to take them, as an alternative;
> >
> > 11.4.2.2 Price Movement - Telecom will charge no more than the standard residential rental for ordinary residential telephone service and from 1 November 1989 the pre-GST standard residential rental will not be increased in real terms provided that overall profitability of the subsidiary regional operating companies, as evidenced by their audited accounts, is not unreasonably impaired;
> >
> > 11.4.2.3 Standard Prices and Availability - The line rental for residential users in rural areas will be no higher than the standard residential rental and Telecom will continue to make ordinary residential telephone service as widely available as it is at the date of adoption of these Articles."

This obligation is known as the Kiwi Share Obligation ("KSO"). It is central to the dispute between the parties. It was common ground that the requirement of KSO involved Telecom in providing local residential calls on an uneconomic basis if costed on a stand alone basis. Local calls from residential users must involve Telecom in costs which cannot be recouped by any increase in real terms in residential rental charges and the provision and maintenance of rural lines must involve greater expense than those of urban lines. It was and is Telecom's case that these additional costs have to be met by a cross-subsidy from its other services. But this economic cost to Telecom of residential and rural services is the "stand alone" cost. Clear argues that when revenues obtained by Telecom from residential and rural users from other services (particularly toll calls) are taken into account, Telecom does not make a loss on its residential and rural services. Therefore, argues Clear, there is no cost subsidy required from Telecom's other services.

The history.

The facts of the case are set out in detail in the judgment of the High Court and are admirably summarised in the judgment of Gault J. in the Court of Appeal. Since the ambit of the dispute before their Lordships is much narrower than in the courts below, it is only necessary to recount the history in outline.

At the date of trial the principal beneficial shareholders in Telecom were four in number, two major United States telephone companies and two New Zealand companies. Clear was incorporated on 1st August 1990 and its principal shareholders at the date of trial were two major United States telecommunication groups and three New Zealand companies.

Since 1st April 1989 all telecommunication markets have been opened to competition. In October 1990 Clear was recognised as a network operator for the purposes of the Telecommunications Act 1987. It has throughout been recognised that the interconnection of Telecom's PSTN to competing services was and is a critical factor in ensuring the introduction of effective competition into the New Zealand telecommunications industry. Telecom has throughout accepted that Clear and other competitors should be interconnected to Telecom's PSTN. For example, on 6th July 1989 the then Chairman of Telecom gave an undertaking that it was:-

> "Telecom's policy to ensure that interconnection will be provided to competitors on a fair and reasonable basis, and that the relationships between Telecom companies will not unfairly disadvantage competitors."

Before Clear's incorporation, there had been negotiations between its promoters and Telecom. These culminated in August 1990 in a Memorandum of Agreement which covered both Clear's toll by-pass service and its proposal for local services. In relation to the latter the terms proposed by Telecom were that:-

1. Where a call was delivered by Telecom to Clear, Telecom would bill the caller at standard local call charge, if any.

2. Where a call was delivered by Clear to Telecom, Telecom would bill Clear at its standard local call charge.

3. Telecom would provide Clear with integrated numbering (i.e. no access code) by supplying blocks of Telecom numbers at tariff rates.

4. Clear would pay the full cost of the necessary links interconnecting its network with that of Telecom.

In March 1991 the parties entered into a final agreement relating to Clear's toll by-pass service and on 4th March 1991 entered into a Restated Memorandum of Agreement relating to Clear's local services. As its name indicates this latter agreement restated the same terms as to local services as those in the original Memorandum of Agreement. It is to be noted that under these terms (a) Telecom did not require any payment for access comparable to the rental charge to ordinary customers but only a traffic charge, (b) Telecom was to be paid for all calls handled by Telecom at its standard rates, such payments being made either by its own customer or by Clear and (c) there was no requirement for any access code.

On 13th March 1991 Clear sought to take the negotiations forward by proposing that there should be no access code required for access to the Telecom system and that there should be no charge (whether by way of rental or traffic charge) by either Telecom or Clear for use of the other's network, save that Clear would make a periodic payment reflecting any imbalance between the calls terminating in the Clear system and those terminating in the Telecom system. As will be appreciated, this proposal was entirely different from that laid down in the Memorandum of Agreement.

Telecom's response over the following months showed a hardening attitude in two respects. First, Telecom demanded an "access levy" based on the propositions (a) that its PSTN was nationwide and much larger in scope than Clear's existing or likely future network and (b) that Telecom had to cross-subsidise its residential and rural services out of its other revenue. Second, Telecom demanded that those dialling into the Clear network should have to use an access code. Clear rejected both these demands, saying that any payment to meet Telecom's internal cross-subsidy arrangements was "incapable of negotiation".

Negotiations continued unsuccessfully. Matters came to a head as a result of a contract prematurely entered into by Clear with the Justice Department relating to the provision of Clear's telecommunication services to the new courts in Wellington. This new system had to be operational by 28th October 1991. On 28th June 1991 Clear asked Telecom to supply a standard Telecom Direct Dial In installation, ("DDI"), which Clear could adapt so as to provide the Gateway service it had contracted to give the Justice Department and for an allocation of ordinary numbers i.e. numbers not using an access code. Telecom considered that this request was an attempt by Clear to find its way round the need for any interconnection fee: the allocation of numbers asked for in conjunction with the DDI installation was very large and, in Telecom's view, could be used as a way round the need for an access code.

On 7th August 1991 Telecom wrote to Clear a letter which stated Telecom's then position which is summarised by the High Court as follows:-

(a) Telecom rejected the DDI interim proposal as being 'not viable' especially given the possible scale of Clear's network and because there was no access code.

(b) Telecom customers must be able to distinguish between services offered by Telecom and those by other operators and the price implications of a call.

(c) Interconnection links would cost Clear the same as any other customer, plus any additional costs incurred.

(d) Call charges would be made for all calls from the Clear network at Telecom's standard rates for business calls.

(e) Call charges to be fixed by Telecom would be made to Telecom customers on all calls to the Clear network to recover Clear's charges to Telecom for the call.

(f) Clear would pay an access levy as a fair contribution to the Telecom network and infrastructure. The quantum was to be established on "proper economic and accounting principles" in consultation with Clear.

(g) An 023 access code would be required to identify calls into the Clear network.

(h) An interim offer to meet the Justice Department requirement was made on terms which proved unacceptable to Clear.

Telecom having rejected the interim DDI proposal and insisted on unacceptable terms for interconnection generally, Clear started these proceedings on 8th August 1991. Clear applied for an interim injunction to force connection of the DDI, which was refused. The parties came to an interim arrangement as to the Justice Department contract.

Following the start of proceedings, Telecom took advice from American economists which produced a major shift in the way Telecom viewed its case. Hitherto Telecom had largely based its demand for an access levy to its network on the ground that it was entitled to a contribution to the cross-subsidy required by the KSO. The American economists advised that Telecom could, without unlawful use of its dominant market position, require Clear to contribute to the general common cost of Telecom's network. This advice was based on what came to be known in the course of the trial as "the Baumol-Willig Rule". This is not a general rule of economic thinking but was coined for the purposes of this case because it was propounded by Professors Baumol and Willig. The Rule will have to be considered in detail later. For present purposes, it is enough to say that the Rule

propounds the proposition that, in a fully contestable market, someone selling to a competitor the facilities necessary to provide a service that the seller could otherwise provide himself would demand a price equal to the revenues he would have received if he had in fact provided the service himself, "the opportunity cost".

As a result of receiving this advice, Telecom reformulated its proposals in letters dated 19th February and 10th April 1992. In outline its proposals were:-

(a) As to access codes, it was proposed that Clear's network be differentiated, but a specific access code would only be required if Clear demanded payment for termination of calls in the Clear network;

(b) Telecom was to charge its own customers its standard call charges for calls into the Clear network and charge Clear its standard call charges for calls from the Clear network into the Telecom network.

(c) Telecom required an access levy in respect of each Clear customer equivalent to the line rental paid by a Telecom customer.

The letter did not disclose that the revised offer was based on the American economists' advice. Clear rejected these proposals, maintaining that no access code was acceptable and that it should have free access to the Telecom network in return for Telecom having free access to the Clear network.

Finally at the trial Telecom put forward a further modified position which constituted its final proposals. These proposals are the key matter for the consideration of the Board in this case. They are summarised by the High Court as follows:-

"(1) As regards the access charge, Telecom will be entitled to the equivalent of a monthly line rental at business rates less any saving in its average incremental cost because Clear puts in the equivalent of the loop to Telecom's switch. This is known as the access levy which is thus equal to net incremental cost plus contribution foregone;

(2) As regards the traffic charge, in respect of a call into the Clear network, it (Telecom) claims to be entitled to be paid by its subscribers (its standard charges) less only that part of Telecom's cost saved by Clear carrying the call part of the way. Conversely it is entitled to charge Clear for the whole of calls entering the Telecom network at its business rates less that part of Telecom's cost saved by Clear carrying the call part of the way.

(3) Telecom claims that Clear should meet the cost of the link constructed by Telecom between the Clear and the Telecom switches ('the bridge') at Telecom's incremental cost.

(4) Telecom accept that necessary periodic adjustments will have to be made.

(5) Telecom further accept that when Clear's local network is 'big enough' there will be reciprocity in the access levy to each competitor's network."

These proposals were intended to be an application of the Baumol-Willig Rule.

Clear's final position at the trial was that there should be no access levy; the KSO should be borne by Telecom alone; the cost of the bridge should be shared equally; there should be either a free exchange of calls or alternatively a settlement regime.

The Baumol-Willig Rule and Competitive Parity.

Professor Baumol, Professor Willig and Dr. Kahn are all distinguished American economists with a very wide experience of competition disputes in the United States and elsewhere in relation to the telecommunications industry.

In a joint brief Professors Baumol and Willig approached the problem on the basis that a business would not be "using" its dominant market position (within the meaning of section 36) if it offered its goods or services to a competitor at the same price as it would in a fully competitive market viz. at marginal cost. However, in their view in an industry which enjoys economies of scale and scope (such as the telecommunications market) marginal cost was not the correct yardstick since such costs would not cover, for example, major fixed costs. In such a case, the correct yardstick is that of the perfectly contestable market i.e. a market where there is ease of entry and where the potential competition precludes monopolistic behaviour and economic inefficiency. In conditions of perfect contestability, a firm will adjust its prices and output "so long as the price and the attendant overall profit do not exceed the competitive levels - the levels that will make entry profitable".

In a fully contestable market, the model imposes the following requirements:

1. There should be differential pricing, with prices that vary in their ratio to marginal costs, from one product line to another and from one customer group to another, inversely with elasticity of demand ("Ramsey Pricing" after the name of the inventor).

2. For each product or service, price should at least cover marginal cost or average incremental cost. It will be necessary that some products deliver a contribution towards covering the common cost arising from the presence of economies of scale and scope.

3. Where the firm supplies components or intermediate goods to another firm "and this process entails some sacrifice of profits by the supplier firm" (as when it thereby gives up some capacity that it would otherwise have used itself), the supplier firm must be permitted to price the article in question at a level sufficient to compensate it for the profit it is forced to sacrifice because of its supply to the other firm. Economists refer to the sacrifice of profit unavoidably entailed in the activity as the "opportunity cost" of that activity. This third pricing principle, then, asserts that the price of any goods or service should cover its opportunity cost as well as any other incremental cost entailed in supplying it. This is how goods are always priced in competitive markets, and how they should be priced in any other market.

4. In the long run, firms should be free to earn a competitive rate of return, that is total revenues would cover total cost.

The consequence of applying this model to the present case is to say that Telecom is acting in a way which does not involve use of its dominant market position if it allows Clear to interconnect to the Telecom network on payment of, first, the average incremental cost to Telecom of supplying the PSTN <u>plus</u> the revenue Telecom would have received had it supplied the service to the Clear customers <u>less</u> the cost saved by Telecom by reason of Clear providing and handling any calls to or from a Clear customer over the sector from the interconnection with Telecom's network and the Clear customer, and vice versa.

Professor Baumol accepted that this model enabled Telecom to secure, by way of payment from Clear, the continued receipt of any monopoly rents present in its existing charging rates. "Monopoly rents" are of two kinds, viz., (1) inefficiencies in the provision of the service giving rise to higher costs and (2) profits in excess of what would represent a reasonable return (including reasonable profit) on capital invested. Neither of these elements would exist or persist in a fully competitive market. However, Professor Baumol did not regard the possible presence of monopoly rents in the charges levied by Telecom on Clear as invalidating his model. First, the model was designed to lay down the basis for fair competition, not to regulate prices. Second, provided that Telecom also charged its customers on the same basis, there was a level playing field in the area in which Telecom and Clear would compete. The sector of the market being contested was limited to the sector of the service lying between the customer and the point of interconnection with

the PSTN: if both Telecom and Clear (and therefore indirectly their respective customers) were charged the same amount for use of the rest of the PSTN, in the area in which they were competing they would be competing on equal terms whatever the amount charged. Clear could compete in the contested area on equal terms. Third, if Clear competed successfully in the contested area at a lower price to its customers, Telecom would be forced to reduce its prices to its customers in order to fight off the competition and would therefore have to reduce "the opportunity cost" element in what it charged Clear i.e. the classic effect of lower prices to the consumer due to competition between the suppliers in the area in which they were in competition. Finally, if the price charged by Telecom to Clear for use of the PSTN was less than the component price charged by Telecom to its own customers, this would tend to produce inefficiency in the competition in the contested area. The aim of competition is to produce for the customer the most efficient system of supply in the contested area. If Clear is not charged the same amount for the use of the PSTN as Telecom is charging itself (and therefore its customers) then Clear can be less efficient than Telecom in the contested area (i.e. the provision of the local service to customers) and still undercut Telecom's prices for a similar service.

Dr. Kahn's evidence was complementary to that of Professor Baumol and Willig. He advanced "the principle of competitive parity". He stressed that, in considering whether competition would be deterred by Telecom's charges, what is pertinent is not the absolute level of those charges but whether Telecom is charging Clear more for the service it provides to Clear than it charges its own customers for the same component of its own services. He accepted that this approach could prolong the receipt by Telecom of monopoly rents; but in his view that was a matter for correction by economic regulation.

The Baumol-Willig Rule in action.

The High Court usefully defined the point at which Clear's network joins Telecom's PSTN as "point alpha". Therefore, the area in which Telecom and Clear will be competitors in local services is for the provision of telecommunication services to and from business customers in the CBDs from the customers' premises to point alpha. The cost of providing and maintaining the loop from Clear's customers to point alpha will be borne by Clear as will the cost of handling the charge over this sector. From then on, such costs will normally be borne by Telecom except to the extent that a call uses Clear's by-pass toll system or is made to a Clear customer in a CBD.

In respect of access to PSTN, the Baumol-Willig Rule permits Telecom to charge Clear, in respect of a call from the Clear network, its ordinary business rental less the

average incremental cost ("AIC") of Telecom providing the loop in the contested area (such costs being borne by Clear) plus the AIC to Telecom of providing the interconnection at point alpha. On the same principle, in relation to calls from the Telecom network into the Clear network, the Rule will permit Telecom to charge its customer its standard charges but Telecom will be liable to pay to Clear its AIC of providing the loop from point alpha to Clear's customers less Telecom's AIC in providing the interconnection at point alpha.

Since the application of the Rule is based on Telecom's standard charges, the charges made by Telecom to Clear must necessarily include any monopoly rents included in Telecom's standard charges. However, the Rule envisages that if Clear is the more efficient provider of the service to point alpha it will be able to charge less for calls for this sector, thereby undercutting Telecom's price for the totality of the call. This competition in the contested area, it is said, will force Telecom to reduce its prices, thereby diminishing its opportunity cost and correspondingly diminishing the amount of the access levy it can charge to Clear. This process of forcing down the price charged by Telecom to Clear will continue until any element of monopoly profit is "competed out" of Telecom's charges. However, it will be apparent that this competing out process requires regular reviews of what are, for the time being, Telecom's opportunity costs being charged to Clear. The Baumol-Willig Rule therefore requires that such reviews must take place regularly.

The decision of the High Court.

The case came before a court consisting of a High Court judge, Ellis J., and a distinguished Australian economist, Professor Maureen Brunt. The case lasted some 37 days. In addition to hearing two senior executives, one from each of the parties, the court received evidence from *inter alia* two distinguished economists tendered by Clear, Dr. Cornell and Dr. Williams, the three tendered by Telecom (of whom Professor Willig was not cross-examined) and two accountants expert in the field, Mr. Hagen for Clear and Mr. Davies for Telecom.

The High Court held that, for the purposes of section 36, the market in which Telecom has a dominant position is the national market i.e. the market within New Zealand for a standard switched telecommunication service (excluding mobile telephone services). As to Telecom's requirement for an access code to be used by Telecom customers dialling into Clear, the High Court considered that, unless linked to an additional charge for the call, this would discourage subscribers dialling the number and therefore have an anticompetitive effect. Telecom had proposed to charge its customers who received a call from Clear a charge reflecting the amount that Telecom would have to pay Clear. This was held by the High Court to be "totally unacceptable". In the view of the High Court, if a satisfactory basis could be

found for charging Clear for calls both into and out of the Clear network, there could be no justification for any access code.

As to the cross-subsidy of residential calls by Telecom's other services as a result of the KSO, the High Court found that, although the matter was finely balanced, "the evidence points to the existence of an element of cross-subsidy". However, they regarded the matter as rather a red herring since, if it was once accepted that Clear had to contribute to the common cost of Telecom's network, any cross-subsidy resulting from the KSO would be included in the common costs of Telecom's network.

The High Court then considered Clear's criticisms of the Baumol-Willig Rule. First, they addressed the question of the monopoly rents. They found that it was self-evident that, if there were monopoly rents included in Telecom's charges (and consequently in Telecom's opportunity cost) adoption of the Baumol-Willig Rule would enable Telecom to continue to recover such monopoly rents. They then made a crucial finding of fact:-

> "The next question is whether there is evidence of such monopoly rents. This was approached in the evidence in two ways: by indirect inference or by direct measurement.
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> Dr. Kahn stated in his brief that Telecom's present charging structure for subscriber access as between CBDs and rural areas is 'symptomatic of an absence of fully effective competition' and that if 'fully effective competition prevailed in the provision of interconnection or that market were perfectly contestable, the price in CBDs, particularly, would be driven down in the direction of the rural charge'. Professor Kahn said that 'the arithmetic does indeed show that in CBDs the contribution is very large'. When asked in cross-examination whether it follows that this is 'use by Telecom of its dominant position in the market', he replied: 'Yes, I think that is fair to say'.
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> The two accounting experts, on the other hand, said in their joint statement that 'no firm conclusions can be drawn' 'either way' from the comparative data included in Mr. Davies' briefs 'about the proposition that Telecom has been earning monopoly profits or has been over-investing in network capacity'. Mr. Davies, in particular, in his oral evidence stressed the difficulties, in principle, of measuring monopoly profits, both overall and especially for segments of a business such as telecommunications. The task is not impossible but would require studies such as those undertaken in the U.K. Monopolies and Mergers Commission, he said. The joint statement included a paragraph on efficiencies:

'We agree that Clear should not be required to contribute towards the cost of any inefficiencies which may exist in Telecom's operations. However, the extent of any inefficiencies is not currently known, and could only be reliably determined on the basis of a further major review of Telecom's operations by a suitably qualified and independent third party.'

In the circumstances it would seem appropriate to remain largely agnostic on the factual situation - not quite, in view of Dr. Kahn's judgment which must be accorded great respect - but then to ask: would such a high monopoly price preclude the development of competition? Would it have an exclusionary effect?"

Later the High Court said:-

"It has not been established to our satisfaction whether or not Telecom is currently earning monopoly rents. But we cannot take the evidence further. This Court is not a regulatory agency. We cannot pursue investigations as to:

(1) Whether Telecom's overall return on shareholders' funds contains monopoly rent;

(2) Whether the particular segments of Telecom's business that enter the Baumol-Willig Rule contain monopoly rents;

(3) Whether Telecom has established excess capacity or wasteful capacity in its networks;

(4) Whether Telecom's operations are conducted in an inefficient manner.

We do not say that a Court such as this can never draw inferences as to the presence of monopoly rents from the evidence before it, but the telecommunications industry is an unusually complex industry."

The High Court next considered whether the amount of the monopoly rents included in Telecom's opportunity cost might lead to the price payable by Clear for access to the PSTN being so high that it could not possibly enter the contested area as competitor at all. So far as their Lordships can detect, the High Court made no finding of fact on this issue specifically, presumably because, having found that the existence of any monopoly rents had not been proved, the point did not arise.

As to the question whether the price being charged by Telecom under the Baumol-Willig Rule might restrict effective competition, the High Court noted that the competition would in the first instance be limited to the sector from the Clear customer to point alpha (i.e. the

contested area). They found that competition in the contested area would be likely and that, although the Baumol-Willig Rule would not immediately eliminate Telecom's monopoly rent, if any, a price which did not require Clear to pay Telecom's opportunity cost (and in particular Clear's suggestion of a free exchange of calls or traffic charges only) would give Clear "a free ride on Telecom's network" and allow Clear to outcompete Telecom in areas where Clear is less efficient. They summarised the position as follows:-

> "Thus in summary, from Clear's perspective, implementation of the Rule would mean that Telecom's inefficiency is protected. But this is on the assumption that the monopoly rents currently exist. From Telecom's perspective, failure to implement the Rule would mean that Clear's inefficiency is protected. But this is on the assumption that the foregone contribution, the 'opportunity cost' of connecting with Clear, is social opportunity cost."

The High Court then gave its overall assessment of a charging regime based on the Baumol-Willig Rule. They noted that the Rule did not address the problem of monopoly rents being so high as to operate to exclude (as opposed to render less efficient) competition by Clear in the contested area. They held (in the second passage quoted above) that the existence of monopoly rents had not been proved and was not capable of ascertainment except by a regulatory agency. They then considered whether the risk of any monopoly rent at a level sufficient to exclude Clear should lead them to reject the Baumol-Willig Rule as a model, but balanced against this risk the certainty that a pricing model which did not charge either for access to Telecom's network or for the incremental cost of interconnection or for the KSO burden would foster inefficiency by Clear and the proliferation of uneconomic operators. They expressed their conclusions on the Baumol-Willig Rule as follows:-

> "In the end it is our judgment that implementation of the Rule is more likely than the alternatives to improve efficient competition in New Zealand telecommunications. In that case, Telecom cannot be said to be using its position of dominance for the purpose of preventing or deterring Clear from engaging in competitive conduct in the New Zealand telecommunications market. If the defendant's conduct is more likely than not, in light of available alternatives, to improve competition, the defendant cannot be said to be in breach of the purpose requirements of s.36. There is an improvement in competition when there is an enhancement of an efficient competitive process. Effect does not necessarily imply purpose. But Telecom's intent can be inferred from an analysis of the true character of the charging regime it proposes.

There is the possibility that the margin offered to Clear will prove to be too small to permit it to earn a sufficient return on its Gateway service, and that in the event it will have been deterred by Telecom's monopoly price for interconnection. But that is not a prospect that this Court can monitor. What we can do is insist, as Dr. Kahn urged, that Telecom charges its rival no higher price than it charges itself, that it observe the non-discriminatory rule of competitive parity."

The High Court therefore held that Telecom was not in breach of section 36 in maintaining its final position as put forward at the trial. Turning to the earlier conduct of Telecom prior to the adoption of the proposal based on the Baumol-Willig Rule at the trial, the High Court held that Telecom had throughout been in breach of section 36. It had failed to make any reduction in its price to reflect the fact that Clear was to provide the loop from Clear's customer to point alpha. It had wrongly insisted on an access code. It failed to offer any machinery whereby reductions in Telecom's prices were reflected in Telecom's costs charged to Clear. Telecom had not recognised (as does the Baumol-Willig Rule) that when Clear had established sufficient customers, Telecom would need access to Clear's network and would have to pay for it. Telecom had never accepted Clear as a network operator but had insisted on treating it as a PABX customer. They concluded that "Telecom has till now demanded more money or contribution from Clear than it can justify", that such demands would prevent or deter Clear from competing and that such demands could only be made by use of Telecom's dominant market position for an anticompetitive purpose in breach of section 36. On the other hand, the High Court rejected a claim made by Clear that Telecom had been in breach of section 36 by reason of its delaying the negotiations.

Clear had claimed damages under section 82 of the Commerce Act 1986 for Telecom's breaches of section 36 which the High Court had found. Such damages were assessed as being Clear's loss of opportunity to conclude negotiations on proper terms at an earlier date. The High Court held that this claim was not maintainable since Clear had throughout rejected any claim for a contribution to Telecom's network costs and they were therefore satisfied that, even if offered connection on the basis of Telecom's final position at trial, Telecom would have rejected the offer.

Finally, the High Court held that Telecom's refusal to connect Clear as a DDI customer for the purposes of the Justice Department contract was a breach of section 36 as a plainly anticompetitive misuse of its dominant division for the express purpose of preventing Clear from getting a toe in the door. The High Court held that Clear was entitled to damages for this breach.

The decision of the Court of Appeal.

Clear appealed to the Court of Appeal against the finding that Telecom's final position based on the Baumol-Willig Rule was not a breach of section 36. Clear further appealed against the refusal to award damages for Telecom's earlier breaches, other than the DDI breach. Telecom cross-appealed against the finding that down to the time of the trial it had been in breach of section 36, including the finding that its refusal to supply DDI was a breach for which damages were payable.

The leading judgment in the Court of Appeal was delivered by Gault J. with whom Richardson J. agreed. He approached the case on the basis that the underlying purpose of section 36 was to promote competition. However he accepted that even a firm in a dominant market position is entitled to compete and the section is not to be construed so as to constrain such competition. He further accepted that a party conducting itself in the same way as it would have done in a fully competitive market would not be "using" its dominant position for the purposes of section 36. He cautioned against the risk of substituting economic models for the words of the statute. He further suggested that, in cases such as the present where one firm controls facilities access to which is essential for any competitor, it may be helpful to consider whether the firm has acted reasonably or with justification.

Gault J., though differing with diffidence from the views of so many distinguished economists, was unable to accept that the Baumol-Willig Rule provided a proper model for determining whether or not Telecom was in breach of section 36. He accepted the first two steps in the Rule viz. that a firm in a dominant position in an industry (such as telecommunications) characterised by economies of scale and scope will not be using its dominant position if it demands the price obtainable in a perfectly contestable market. However, he was not convinced about the next step, viz. that the price properly demanded by a firm controlling an essential service in a perfectly contestable market would include opportunity costs. After noticing that Telecom's experts agreed that opportunity costs or charging on the parity basis might result in monopoly rents being included in the price charged, he said that in a perfectly contestable market monopoly profits would not be obtainable and that this factor casts doubt on the validity of the model altogether. He did not accept Dr. Kahn's view that the inclusion of monopoly profits in any access levy would not have competitive implications unless they reduced demand: in his view the inclusion of monopoly profits "must affect the price at which Clear can enter the market and so affect the vigour of its competitive conduct".

Gault J. then held that it would be unrealistic to ignore the presence of monopoly rents in Telecom's charges. It is not clear to their Lordships whether he was actually overruling the High Court's decision that the existence of such monopoly rents had not been proved or was merely stating that in the circumstances it was impossible to ignore a high risk that they were present.

Gault J. did not accept the argument that monopoly rents would be eliminated by competition. First, such argument did not deal with risk that the price being demanded by Telecom was so high that it would prevent Clear from entering the market at all. Second, the time lag inherent in the review process necessary to reflect any decrease in Telecom's charges would allow Telecom to exploit its price changes before they were reflected in the costs charged to Clear.

As to the evidence of Telecom's experts that regulation, not pricing principles, was the appropriate mechanism for getting rid of monopoly profits, he said that "in view of stated Government policy it would be unrealistic to leave the matter for regulatory intervention".

As to the requirement that Telecom must be shown to have used its position "for the purpose of" restricting competition, Gault J. held that such purpose was to be inferred from "the inevitability of the consequences of refusing to deal except on terms that lead to competitive disadvantage". In addition he relied on indications from Telecom's documents that, subjectively, Telecom intended to deter competition by Clear.

Gault J. did not deal separately with the legality of Telecom's conduct prior to trial but held that throughout Telecom's negotiating stance was in breach of section 36.

Turning to Clear's claim for damages for breach, based on the lost opportunity to negotiate an earlier interconnection, Gault J. upheld the High Court's decision that no right to damages had been established. He pointed out that Clear had throughout refused to pay any access levy. He therefore had to consider the question whether, even though an access levy based on the Baumol-Willig Rule was, in his judgment, inappropriate, Telecom could properly have demanded an access levy on some other basis. For this purpose, Gault J. created his own economic model and held that Telecom could properly seek a contribution to the common costs of operating and maintaining its network since Clear would be using that network. But the only cost recoverable would be the "true cost" by which he meant average incremental cost plus "a reasonable return on capital ... employed". This model would certainly eliminate any element of monopoly profits: it is not clear whether Gault J. meant also to eliminate excess costs due to monopoly inefficiency. Once the true costs of the Telecom network had been established, Gault J.'s model required Clear to contribute to such costs "in

proportion to benefits", the method of assessing and apportioning such benefits not being explained. Therefore, since Telecom could have legitimately required some contribution to network costs and Clear would have refused to agree such contribution, Gault J. held that Clear had not shown that it had suffered any loss from Telecom's breaches (other than the DDI installation).

Sir Robin Cooke P. agreed with Gault J. and added a short judgment of his own. He concentrated on a passage from Professor Baumol and Professor Willig's evidence which stated that the supplier of a product component should not be forced to receive for it "less than the price that makes the supplier indifferent as to whether the other components of the final product are provided by itself ... or whether, instead, those remaining components are supplied by others". He said that such a principle was obviously anticompetitive since it would "amount to allowing a new entry into a market on condition only that the competitor indemnify the monopolist against any loss of custom". He treated the process whereby, in the view of Telecom's experts, the new entrant would compete out Telecom's monopoly profits as hypothetical, since Telecom might prefer to rely on receiving the high price from Clear rather than lower its own prices. He was further of the view that regular reviews of the access charge which are necessary to operate the Baumol-Willig Rule "would mean a vista of continual disputes or arbitrations, so daunting in itself as to transgress the Commerce Act". He stated the correct principle applicable to the price of interconnection as being:-

> "... that Telecom is entitled to a fair commercial return for granting Clear use of the network assets, without regard to the present monopoly. This means that opportunity cost should be ignored and the charge fixed on the basis of what a network owner not in competition for the custom of subscribers could reasonably charge for use of its facilities."

The issues before the Board.

Telecom appeals to the Board against the decision of the Court of Appeal that Telecom's final position, based on the Baumol-Willig Rule, breached section 36. Telecom further appeals against the decision that it was in breach of section 36 in refusing to supply DDI for the Justice Department contract. Clear cross-appeal against the finding of the Court of Appeal that Clear is not entitled to any damages for Telecom's breaches of section 36 (other than the DDI contract).

The construction of section 36.

Before turning to the resolution of the present case, in their Lordships' view there are a number of points on the construction of section 36 which need to be referred to.

(1) In order to show a breach of section 36, three elements have to be present:

(i) a person who has a dominant position in a market;

(ii) who has used that dominant position;

(iii) for the purpose of the matters referred to in sub-paragraphs (a), (b) and (c) of sub-section (1).

In the present case there has never been any dispute that Telecom is in a dominant position in a market which, it is now common ground, is the New Zealand national market. The issues are whether it has "used" that position and, if so, whether such use was "for the purpose of" producing results (a), (b) or (c). The use of a dominant position otherwise than for one of those purposes does not constitute a breach. Contrariwise, the fact that a person has acted in order to achieve one of the purposes (a), (b) or (c) does not constitute a breach unless he has used his dominant position to achieve those purposes.

(2) Before considering the "use" requirement, it is convenient to consider the "purpose" requirement. If a person has used his dominant position it is hard to imagine a case in which he would have done so otherwise than for the purpose of producing an anticompetitive effect; there will be no need to use the dominant position in the process of ordinary competition. Therefore, it will frequently be legitimate for a court to infer from the defendant's use of his dominant position that his purpose was to produce the effect in fact produced. Therefore, as the Court of Appeal in the present case accepted, use and purpose, though separate requirements, will not be easily separated: see *Electricity Corporation Ltd v. Geotherm Energy Ltd* [1992] 2 N.Z.L.R. 641; *Union Shipping New Zealand Ltd v. Port Nelson Ltd* [1992] 2 N.Z.L.R. 662.

Although it is legitimate to infer "purpose" from use of a dominant position producing an anticompetitive effect, it may be dangerous to argue the converse i.e. that because the anticompetitive purpose was present, therefore there was use of a dominant position. Telecom's relationship with Clear is not only that of supplier and customer; Clear will also be Telecom's competitor in the provision of telecommunications in the CBDs. It is unavoidable that, as a competitor, Telecom will be seeking in one sense to "deter" Clear from competing successfully. A monopolist is entitled, like everyone else, to compete with its competitors: if it is not permitted to do so it "would be holding an umbrella over inefficient competitors": see *Olympia Equipment Leasing Company v. Western Union Telegraph Company* F. 2d 370 (7th Cir. 1986) per Posner J.; *Union Shipping New Zealand Ltd v. Port Nelson Ltd (supra)* at page 706; *New Zealand Magic Millions Ltd v. Wrightson Bloodstock Ltd* [1990] 1 N.Z.L.R. 731 at 761; *Queensland Wire Industries Pty. Ltd v. Broken Hill Pty. Co. Ltd.* (1988) 167 C.L.R. 177 at page 191 per Mason C.J. and Wilson J.

Their Lordships have emphasised this point because Telecom's submissions before the Board concentrated on seeking to show that Telecom did not have an anticompetitive purpose. This was a hopeless task not only because it would be most improbable that Telecom lacked the purpose to deter its bitter rival, Clear, but also because its past conduct and certain of its internal memoranda show that in fact it did have that purpose. However, it does not follow from the existence of Telecom's anticompetitive purpose that Telecom has used its dominant market position. In their Lordships' view that is the critical question.

(3) As to what constitutes "use of a dominant position", although their Lordships agree with Gault J. that ultimately the question depends upon the true effect of the statutory words used in section 36 and not on any economic model, the statutory words provide no explanation as to the distinction between conduct which does, and conduct which does not, constitute such use. Both the High Court and the Court of Appeal proceeded on the basis, with which their Lordships agree, that if the terms Telecom were seeking to extract were no higher than those which a hypothetical firm would seek in a perfectly contestable market, Telecom was not using its dominant position. In order to discover what such hypothetical terms might be it is inevitable that the parties and the court must have recourse to expert economic advice. The Baumol-Willig Rule is a closely reasoned economic model which seeks to show how the hypothetical firm would conduct itself.

(4) If, as their Lordships consider, it is legitimate and necessary to consider how the hypothetical seller would act in a competitive market, attention must be directed to ensuring that (apart from the lack of a dominant position) the hypothetical seller is in the same position vis-a-vis its competitors as is the defendant. Thus in the present case it is the fact that Telecom is both a supplier of an essential service to Clear and a competitor of Clear in the contested area that makes the case so difficult. It is essential that this duality of role is not ignored, since otherwise the comparison is a false one. For this reason their Lordships have reservations about the principles stated at the end of Cooke P.'s judgment viz. that Telecom's charges should be paid on the basis of what "a network owner not in competition for the custom of subscribers" would charge. Such a formula does not reflect the actual position in which Telecom finds itself.

(5) Their Lordships also have reservations concerning the view of Gault J. that it may be helpful, in construing or giving effect to the words of section 36 and in deciding whether "use" has been made of a dominant position, to ask whether the defendant has acted reasonably or with justification. If this were, in itself, the test of "use" of a dominant position, then a monopolist firm would be placed in an impossible position. If asked by a competitor

to provide an essential service the monopolist could have little idea what, in the future, a court would find to be reasonable or justifiable. Different minds can easily reach different views on what is reasonable or justifiable. Yet if a court subsequently were to disagree with the monopolist's genuine assessment that he was acting reasonably or with justification, the consequence would be that not only would he be liable for substantial damages but he might also have exposed himself (in the case of a corporate monopolist) to a quasi-criminal penalty of up to $5 million under section 80 of the Commerce Act. In their Lordships' view, section 36 must be construed in such a way as to enable the monopolist, before he enters upon a line of conduct, to know with some certainty whether or not it is lawful.

In their Lordships' view it cannot be said that a person in a dominant market position "uses" that position for the purposes of section 36 unless he acts in a way which a person not in a dominant position but otherwise in the same circumstances would have acted.

(6) It is important to bear in mind that the burden of proving a breach of section 36 lies on Clear as plaintiff. This is of particular importance in relation to the question of monopoly rents. It is also significant in considering whether Telecom's monopoly profits (if any) will produce so high a price to Clear that Clear would be prevented from entering the market at all.

(7) The courts below have rightly emphasised that, in exercising their jurisdiction in deciding proceedings brought under section 36, they are not acting as regulators. However, it is important to note that section 36 is only one of the remedies provided by the Commerce Act for the purpose of combatting over-pricing due to monopolistic behaviour.

Part I of the Act establishes the Commerce Commission. Part II deals with restrictive trade practices, including anticompetitive price fixing agreements (sections 27-34), use of dominant position in a market (section 36) and resale price maintenance (sections 37-45). Part IV deals separately with control of prices. Under section 53 the Governor-General, on the recommendation of the Minister, may declare that the prices for goods or services of any description supplied to or for the use of different persons are controlled. Under section 53(2)(a) a Minister cannot make such a recommendation unless he is satisfied the goods or services are supplied in a market "in which competition is limited or is likely to be lessened". Under section 70 the Commission may authorise a price to be charged for controlled services. Therefore section 36 is only part of an overall statutory machinery for dealing with trade practices which operate to the detriment of consumers. Another part of such machinery (Part IV) is specifically directed to the regulation of prices in markets which are not fully competitive.

The Baumol-Willig Rule - the Recantation.

Mr. Fogarty, for Clear, drew their Lordships' attention to two articles in the Yale Journal on Regulation, Volume 11, Number 1, Winter 1994 which, he submitted, amounted to a recantation by Professor Baumol and Dr. Kahn of the evidence they gave in this case.

In the first article, Professor Baumol after referring to the judgment of the Court of Appeal in the present case said (at page 195):-

> "Given these circumstances, we must sympathise with the reasoning of the Court of Appeal. As we explain elsewhere, the efficient component-pricing rule plays its full beneficial role only when adopted as part of a set of complementary rules designed to promote consumer welfare. One such rule is that a monopolist should not be permitted to charge a price for a final product sold to consumers that is higher than the price that would attract an efficient entrant into the market - a price equal to the stand-alone cost of producing that final product. But, as Justice Cooke noted, no such price ceiling exists under the current laws and regulations of New Zealand. It is therefore understandable that the Court of Appeal ordered Clear and Telecom to renew negotiations to set an access price that excluded any monopoly profit foregone by Telecom."

Later, after referring to the possible perpetuation of monopoly rents if opportunity costs are charged to an entrant, Professor Baumol said (at page 196):-

> "All this is true, but the villain is not the efficient component-pricing rule. The real problem is that the landlord has been permitted to charge monopoly prices for the final product in the first place. Had the ceiling upon final-product prices been based on stand-alone cost, which as we explain elsewhere it should be, the landlord could never have earned a monopoly profit in this regulatory scenario. The error, therefore, is the failure to impose the stand-alone cost ceiling on the final-product price, not the use of the efficient component-pricing rule."

In their Lordships' view, the statements by Professor Baumol are not a recantation by him of his evidence given in this case. Throughout, he has accepted that the Rule will initially perpetuate monopoly rents until either (a) they are competed out by Clear's competition in the contested area or (b) they are removed by regulatory action. He is not apparently aware that Part IV of the Commerce Act does in fact provide for a regulatory machinery which could be, but has not been, brought into operation.

Dr. Kahn also accepted throughout his evidence that, in the absence of regulatory control, his theory of competitive parity led to the possible continuance of monopoly rents. In the second article (at page 231-2) he persists in that view, although he too is under the misapprehension that no machinery exists in New Zealand to regulate the prices charged by Telecom to Clear.

Their Lordships find nothing in these articles which alters the substance of the evidence considered by the High Court and the Court of Appeal. The principal question remains, as it always was, whether the actual or potential presence of monopoly rents vitiates the validity of the Baumol-Willig model for the purposes of section 36.

The Baumol-Willing Rule - apart from monopoly rents.

It will be clear that the main, and most important, issue is whether the potential for a charge fixed on the basis of the Baumol-Willig Rule including monopoly rents currently charged by Telecom prevents that Rule being an adequate model. However the Court of Appeal voiced other criticisms of the Rule, which criticisms were adopted by Mr. Fogarty as part of his argument before the Board.

(a) The theory of opportunity costs.

Professor Baumol stated his third proposition as follows:-

> "Third, the competitive market standard requires that when one firm provides facilities or some other inputs to another firm, and this process entails some sacrifice of profit by the supplier firm (as when it thereby gives up some capacity that it would otherwise have used itself), then the supplier firm must be permitted to price the article in question at a level sufficient to compensate it for the profit it is forced to sacrifice because of its supply to the other firm. Economists refer to the sacrifice of profit unavoidably entailed in an activity as the 'opportunity cost' of that activity."

Gault J. commented on this as follows:-

> "The passage emphasised constitutes a specified condition for pricing on the basis of opportunity cost. But it seems to me that in a perfectly contestable market if there is one supplier sacrificing profit there will be a rival or potential entrant in a position to supply without sacrificing profit. If not there is a monopoly supplier in the market which is contrary to the hypothesis. I am not convinced of the logic at this point."

Their Lordships do not share the doubts of Gault J. As has been said above, the object of the enquiry is to discover whether the terms being demanded by Telecom are higher than would have been demanded by a firm, not in a dominant position, which is being asked to supply a component of the service to a competitor. The enquiry is looking solely to the

conduct of the supplier in question, not at the price at which the would-be competitor could obtain the service from other suppliers. Professor Baumol in his brief and oral evidence fully explains his reasoning in reaching his conclusion. Shortly stated it comes to this. Even in a fully competitive market someone (X) earning a net profit of, say, $1,000 per month from the use of one of its assets is not going to provide the use of that asset to another at a figure less than $1,000 per month. In a competitive market the would be buyer might be able to obtain the use of a similar asset from another and possibly at a lower price. But X will not be acting uncompetitively if he refuses to deal at a figure less than that which he is currently receiving. So, in the present case, Telecom would be acting uncompetitively if it refused to permit Clear to interconnect with Telecom's network. But it is not acting uncompetitively in charging its opportunity cost since that is what it would have charged in a fully competitive market.

(b) The costs and delays caused by reviews.

It is an essential feature of the Baumol-Willig Rule that the charges levied by Telecom on Clear for access should be subject to regular review to ensure that they reflect the downward trend in Telecom's opportunity cost expected to result from Clear's competition. Cooke P. thought that this factor alone was enough to constitute a breach of section 36 since an entrant would not agree to such a term in a competitive market. Gault J. thought that such reviews would leave Clear at a competitive disadvantage because of the time lag between Telecom's change in prices and the date of review.

Their Lordships have not been able to trace the evidence on which Cooke P. founded his view. But in any event it seems inherent in any system providing for a contribution to network costs that the amount of such contribution will have to be revised and reassessed from time to time as such costs change. If it is not done, either Clear will be paying too much (thereby limiting its ability to compete) or too little (thereby providing it with a subsidy from Telecom). It should be noted that the basis of charging based on true costs proposed by the Court of Appeal itself involves periodic reviews as to the amount of such costs and the proportion of the benefits derived from use of the PSTN.

As to the criticisms of Gault J., the High Court expressly stated that such reviews would have to compensate for the time delay by a suitable award of interest or compensation for the time lag involved.

<u>The Baumol-Willig Rule - monopoly rents.</u>

This is the essential issue in the appeal and the critical point on which the High Court and the Court of Appeal disagreed. The question is whether the actual or

potential presence within Telecom's existing charges of monopoly rents which, under the Baumol-Willig Rule, will be handed on to Clear in the guise of opportunity cost, renders the Baumol-Willig Rule an unsuitable model for assessing whether or not Telecom has been acting in a way which it would not be able to do apart from its dominant position.

The first question is whether it has been proved that Telecom's charges do in fact include monopoly rents. As the passages cited from the judgment of the High Court show, the High Court found that the burden of proof had not been discharged: they were not satisfied that there were any monopoly rents included in the charges currently levied by Telecom. Dr. Kahn's evidence was that the fact that business users in the CBDs and business users outside those areas paid the same access charge, even though Telecom's costs for the former must be lower than for latter, indicated the charging of a monopoly rent. On the other hand the parties' two accountants in the joint agreed statement found that neither monopoly profits nor monopoly inefficiencies had been demonstrated. As to the latter they said it was impossible to determine whether or not they existed without a major review of Telecom's operations by a suitably qualified and independent third party. In those circumstances, in their Lordships' judgment, the High Court was fully entitled to reach the conclusion that Clear had not discharged the burden of proving the existence of monopoly rents. If and to the extent that the Court of Appeal purported to reverse this finding, in their Lordships' view they were not entitled to do so since there was ample evidence to justify the High Court's conclusion.

However, both the High Court and the Court of Appeal were fully entitled, as they did, to take into account the risk that monopoly rents were present in Telecom's charges. The High Court considered that, in the context of section 36, this did not vitiate the Baumol-Willig Rule as a proper model for assessing the behaviour of a hypothetical firm in a competitive market. The Court of Appeal took the opposite view viz. that it demonstrated the Baumol-Willig Rule could not be a suitable model for section 36 purposes. As Gault J. said, "I cannot accept that the objects of the Commerce Act are served by a method of pricing that secures the profits of a firm in a dominant position".

Their Lordships are of the view that, apart from the risk of monopoly rents, the Baumol-Willig Rule does provide a proper model for demonstrating what would be charged by the hypothetical supplier in a perfectly contestable market. It follows that Telecom, in basing its charges on that Rule, would not be using its dominant position to extract such terms. The Baumol-Willig Rule itself and Dr. Kahn's principle of comparative parity are designed to ensure that Clear and Telecom compete on a level playing field in the area in which they are to be competitors since both will be charged (and therefore hand on to their respective customers) the same amount for use of the PSTN from point

alpha onwards. The superior efficiency of one or the other in the only sector in which Clear has chosen to compete (local services for business users in CBDs) will dictate commercial success in that area. The High Court were satisfied that such competition would occur and that as a result any monopoly profits would be competed out. This finding of fact, in their Lordships' view, is inconsistent with the fears of Cooke P. that Telecom would prefer to take its existing contribution (including an element of monopoly profits) rather than compete. It is to be noted that it has not been established by Clear (nor can it be regarded as a serious risk) that Telecom's charges will be so high that Clear will be unable to enter the CBD market at all. Surprisingly, Clear did not produce any of its figures to the court. As a result Clear could not make any factual case that it would be altogether prevented by the level of Telecom's charges from entering the market at all.

It follows that the risk of monopoly rents has no bearing upon the question whether the application of the Baumol-Willig Rule prevents competition in the contested area. If both Telecom and Clear are charging their customers the same amount in the area in which they are not competitors (i.e. point alpha onwards) this does not have any effect on their relative competitiveness in the area in which they compete (i.e. up to point alpha). Therefore the underlying object of section 36 will be achieved if the Rule is applied. The question is whether (as the Court of Appeal plainly thought) section 36 has some wider purpose than to enforce fair competition in a market where one firm is in a dominant position. The Court of Appeal took the view that section 36 had the wider purpose, beyond producing fair competition, of eliminating monopoly profits currently obtained by the person in the dominant market position. Their Lordships do not agree.

Monopolies act to the detriment of the consumer by permitting the monopolist to charge higher prices than would be the case if there were a fully competitive market. This problem can be tackled in one or other or both of two ways viz. by a regulatory body artificially restricting the price chargeable or by introducing efficient competition. The introduction of efficient competition (by such anti-trust legislation as section 36) does not in itself instantly remove the evils of the monopolist's overcharging: it produces the conditions which, by market forces, eventually force the monopolist to operate efficiently (and therefore more cheaply) and to abandon policies of excessive charging. Such legislation is neither effective nor apt to take the place of a regulatory proceeding which, after detailed investigation of the efficiency of the monopoly system, can set a maximum price for goods or services to be supplied having regard to economies that could be affected and a reasonable rate of return. The Commerce Act, *inter alia*, directed itself to both these processes: section 36

is designed to produce the competition which will, it is hoped, in due course compete out monopoly rents: Part IV of the Act enables immediate price restriction to be imposed by regulation.

Since the Commerce Act contains the machinery for dealing with the monopoly rents in both ways, it would, in their Lordships' view, be wrong to construe section 36 so as to extend its scope to produce a quasi-regulatory system which the Act expressly provides for, with all the necessary powers and safeguards, in another part of the Act. The consequences of so doing could be unjust and would be impracticable.

In the view of the Court of Appeal, provided the necessary purpose of deterring competition is present, any charge made by a firm in a dominant position to a competitor would constitute a breach of section 36 (giving rise to very great penalties) if it included monopoly profits. Monopoly profits consist of sums charged in excess of a reasonable return on capital invested (including a reasonable profit). On the Court of Appeal's view, any monopolist faced with a request to supply a competitor would be forced to assess its whole financial structure with a view to putting a proper figure on the present value of capital investment and fixing a proper return on such a figure. These in themselves are difficult and contentious matters. When, as in most cases, the process will involve component pricing and the resultant allocation of common costs between particular sectors of the business the operation is even more time consuming and controversial.

The position is made very much worse if, as is logically necessary, the monopolist must exclude not only monopoly profits but also excess charges due to monopoly inefficiency i.e. he must exclude monopoly rents as a whole. If inefficiencies due to monopoly are to be excluded, a person faced with a request for supply will be required to survey the whole of his organisation to discover, for example, whether there is overmanning or inefficient use of plant, factors which are in themselves highly controversial. As the experts agreed, and as the High Court found, such investigations are the function of regulatory bodies who can make decisive value judgments. They are the daily diet of a regulatory body. Such issues could not satisfactorily be carried out unilaterally by the monopolist since he could not know whether the value judgments necessarily involved will be found to be acceptable either to the competitor or, subsequently, to a court hearing proceedings under section 36. Indeed, the same difficulties would apply if the Court of Appeal's own model was accepted i.e. that Telecom was entitled to charge by reference to its "true costs".

Gault J., as has been pointed out, thought that it would be "unrealistic" to leave the matter of monopoly profits to regulatory intervention because of the Government's adoption of what is called light-handed regulation i.e. to leave the question of the terms of interconnection to market

forces rather than regulation. If, as their Lordships consider, on the true construction of the Commerce Act, section 36 does not operate to exclude Telecom from initially charging monopoly rents (if any) and the elimination of such monopoly rents is (otherwise than by competition) within the province of Part IV of the Act, it is irrelevant to the court's function to take into account Government policy. The Government can either adopt the policy of leaving Clear's competition to compete out Telecom's monopoly rents (if any) or activate the Part IV machinery which is available. The Part IV machinery does not require the imposition of any general regulatory regime presiding over the telecommunications industry. It can, if desired, be limited so as to fix the price chargeable for interconnection by Telecom. But what policy the Government adopts is no concern of the courts.

Therefore, in their Lordships' view, the final position adopted by Telecom at trial based on the Baumol-Willig Rule did not breach section 36 since it did not involve the use by Telecom of its dominant position. The Board would echo the sentiments of the courts below as to the sterility of these proceedings which, having been pursued right through the appeal procedure, still do not determine the terms on which Clear's local service is to be connected to Telecom's network. However it is right to record that, at the end of the argument before their Lordships, the parties indicated that their negotiating positions are coming close together. Clear now accepts that it must pay something (in excess of traffic charges) for access to Telecom's network, such payment being based on Telecom's true costs including a reasonable return on capital. On the other side, Telecom accepts that it should not seek to recover any element of monopoly rents from Clear since, if necessary, such monopoly rents could be stripped out by the activation of Part IV of the Commerce Act.

The DDI claim.

Telecom appeals against the decision of both the High Court and the Court of Appeal that it was in breach of section 36 by refusing to supply its DDI system to Clear for the purpose of discharging its contractual obligations to the Justice Department. Telecom's grounds for such appeal are purely factual. It is not the practice of the Board to entertain appeals against concurrent findings of fact by the courts below. In any event their Lordships can see no grounds for differing from such findings.

The cross-appeal - damages.

The High Court dismissed Clear's claim for damages for Telecom's breaches of section 36 (other than the refusal to supply DDI) on the grounds that Clear had refused to accept the terms fixed on the basis of the Baumol-Willig Rule (which the High Court had held lawful) and would have refused any terms which would have bound Clear to pay an access charge.

The Court of Appeal also dismissed the claim for damages on the basis that, although it was unlawful for Telecom to demand terms based on the Baumol-Willig Rule, Telecom could lawfully demand some access charge to cover its network costs and that Clear would have refused such offer in any event since it would not have agreed to pay any access charge.

There are therefore concurrent findings of fact that Clear would not have accepted any terms involving the payment of an access charge. Their Lordships are not prepared to review those findings, which they think to be correct.

It necessarily follows that Clear cannot be entitled to any damages. The claim is based on the value of the lost opportunity to negotiate, at an earlier date, fair terms for interconnection. If Clear could have demonstrated that it would have taken advantage of such an opportunity, if available, then the quantum of damage suffered would have been fixed by reference to the value of the chance to reach an earlier settlement. It would not have been required to prove on balance of probability that it would in fact have reached a settlement. But it having been decided that Clear would not have accepted the chance if fair terms had been offered, Clear has not shown that the chance had any value at all. It has therefore not proved any recoverable damage.

Conclusion.

In the result their Lordships are of the view that the appeal should be allowed to the extent that the declaration in paragraph 1 of the order of the Court of Appeal should be set aside and that there should be substituted a declaration that the terms for interconnection set by Telecom in their proposal of 7th August 1991 as varied down to the date of trial contravened section 36 but that the terms of interconnection proposed by Telecom at the trial did not contravene that section. In addition the order of the Court of Appeal as to costs should be set aside; instead there should be no order. Paragraphs 2 and 3 of the Court of Appeal order (dismissing the claim by Clear for an enquiry as to damages and affirming the finding of Telecom's liability to pay damages for failure to supply the DDI facility code) should be affirmed. Their Lordships will humbly advise Her Majesty accordingly. There will be no order as to costs before their Lordships' Board.