Australian Telecommunications Users Group

10th March 2005
Graeme Samuel, Chairman

Ladies and gentlemen,

If you were to believe much of the commentary of recent months you might think the Australian Competition and Consumer Commission has just one aim in mind – to break up Telstra; restrict its profitability; ensure its market share declined and limit its ability to move into new and emerging markets.

Well let me start today by assuring you that the aim of the Australian Competition and Consumer Commission is not to make life tough for Telstra.

It is not now, and never will it be, our aim to stop Telstra from competing vigorously for new customers and markets and nor will we stop it legitimately exploiting its economies of scale and scope. What we are about is developing, to the best extent possible under the existing structure, a truly competitive environment in all aspects of telecommunications.

In an ideal world such competition would be achieved by standing back and allowing all players to compete vigorously and fairly on price, performance and product.

But when you have such a dominant player in any market, such as Telstra is in virtually all areas of telecommunications, the only way to even begin to achieve that is through regulation.

Even then, it has become increasingly clear to the Commission that there are limits on the extent to which effective and sustainable competition between Telstra and its competitors is possible under the current telecommunications regime.

It is, therefore, appropriate to reflect on some of these limitations and consider options for the most appropriate way forward.

Current environment and potential for disruption

In its first few years the current regime delivered real benefits as competitors entered the telecommunications market, protected to a certain extent by regulated interconnection rates. Costs for mobiles and fixed line service fell sharply and the range and quality of products and services offered to customers improved substantially.

However, the competition that has emerged from this initial process continues to be heavily dependent on access and re-sale arrangements with competitors simply buying space on the Telstra network and competing on price rather

than building their own facilities and offering different products and better performance.

In the absence of any significant national roll out of competing infrastructure, it has not been possible to fully realise the benefits of more sustainable competition across the entire telecommunications sector. As a result, maintaining competition has required an even greater reliance on access regulation – instead of the winding back that was envisaged when telecommunications was opened up to full competition.

It has been suggested by some commentators that this concern will diminish as technological developments chip away at the dominance of Telstra. New technologies, such as wireless local loop and fibre-to-the-home, for example, have been touted as potential threats to Telstra's control of the copper access network which connects virtually every Australian home.

It is our view, however, that such bullish forecasts for competition resulting from new and emerging technologies must be approached with caution. While there certainly is potential for greater competition as a result of these technological advances, their long-term impact on the industry is yet to be demonstrated, and can easily be circumvented by Telstra.

For example, instead of weakening its hold on the market, there is a great incentive for Telstra to respond to the roll out of new technologies, such as wireless, by using its current monopoly position to actually extend its dominance. Should this eventuate, our concerns regarding the current state of access-based competition are likely to be further reinforced.

In light of these issues, the Commission does not resile from its previously expressed position relating to the vertical and horizontal separation of the incumbent. But these issues are ultimately policy matters for determination by parliament.

As for fibre to the home, Telstra keeps saying that only it has the capacity and the expertise to deliver on this promise.

In recent weeks we have heard Telstra complain of overzealous regulation stifling its roll-out plans for taking fibre out to customers. They also point to the US which, they will tell you, is now embarked on a massive fibre roll-out program all because the Federal Communications Commission has decided not to impose access obligations on such roll-outs by the RBOCs (incumbent carriers).

At the risk of letting the facts get in the way of what looks like a remarkably simple and compelling story, the following points should be kept in mind:

First, there are already provisions in the *Trade Practices Act* which enable the regulatory settings to be determined in advance of any new investment being made – and thereby providing the requisite degree of regulatory certainty that they seem to be seeking. These provisions range from a complete exemption

of the new assets from any access obligations to the imposition of a more limited access regime through special undertakings.

Any such decision by the ACCC would of course depend on the application made, an analysis of the underlying technical, commercial and economic issues raised and would need to be on the basis that it is in the long-term interests of end users.

Second, notwithstanding these provisions, Telstra has not chosen to enter into any sort of serious dialogue with us on these matters. Indeed, Telstra admits it actually has no current plans for any significant investment in fibre to the home and claims the existing copper network has another 15-20 years of useful life in front of it[1].

So it's hard to know exactly what Telstra is seeking: a complete exemption, a special access regime or some special treatment involving the use of separate legislation.

If Telstra is really serious about discussing these very important issues to the future of the communications and telecommunications industries in Australia, the ACCC remains ready and willing to discuss and consider any specific proposals from Telstra on its fibre roll-out plans. I would suggest that constructive engagement on these issues would be far more productive than a public slanging match conducted through the media.

I should emphasise that if there were a serious proposal to replace the current copper network with fibre that would be a very welcome development. It would have a huge capacity and be able to provide completely new services to customers and current services more efficiently; it would allow the complete modernisation and refurbishment of networks. This would be a significant benefit to both Telstra and its customers.

Should any application for regulatory certainty also involve third-party access rights, it would also have to address the appropriate access price. In this regard, the ACCC would be mindful of ensuring facilities owners are properly compensated for all their costs that are reasonably and efficiently incurred in building and operating the asset, including a sufficient return to capital (including shareholders) commensurate with the risks that would be involved in such an investment.

Let me make it clear that this is not about access seekers getting access at marginal cost or a free ride, but equally, if access is seen as important, it should not be about the facilities owner being able to exclude access altogether by setting prices at uneconomic levels and sparking wasteful duplication like we had with Pay TV.

[1] Reference Bill Scales testimony to Senate Communications Estimates Committee, 14 February 2005, p.114

As for the apparent US policy of providing exemptions to incumbent carriers in terms of their fibre roll-outs, we should be clear that underlying the US position is a very different industry structure to that of Australia. Unlike Australia, there is considerable and growing competition between telecommunications and cable TV providers for broadband, Pay TV and telecommunications services. So whatever the specific merits of the FCC's approach, this type of inter-modal competition allows regulators in the US to be more sanguine about access requirements than is likely to be the case here for quite some time.

Primary concern – internal integration and transparency

The lack of transparency in the way that Telstra operates is a significant impediment to the effectiveness of the telecommunications-specific provisions of the *Trade Practices Act* in promoting competition.

Previous attempts to address this issue, such as the introduction of the enhanced accounting separation regime in 2002, have not succeeded in giving us a satisfactory handle on the way that Telstra operates its business.

The accounting separation regime was originally intended to provide greater transparency in the way Telstra conducts its retail and wholesale operations to enable us to easily identify any discriminatory behaviour towards rivals seeking access to its network.

However, information provided by Telstra under these arrangements is highly aggregated, which can hide specific instances of anti-competitive behaviour requiring more detailed analysis. It is significant that the Commission has relied on the existing accounting separation arrangements only to a very limited extent in relation to its imputation testing analysis of specific cases.

More importantly, the primary limitation of the accounting separation arrangements is that they require only a notional allocation of costs across the wholesale and retail businesses.

The arrangements do not require the carrier to reorganise its internal affairs and operate as if it were running two or more separate discrete businesses. In the absence of structural reform, stronger measures along these lines would offer a far superior means of both detecting and fixing anti-competitive behaviour.

This view is not unique. The UK telco regulator Ofcom has called for greater separation of BT's wholesale and retail operations as part of its *Strategic review of telecommunications*. Ofcom has proposed that BT deliver 'equivalence of access' to its wholesale customers, and also introduce internal changes to reduce the incentive for BT to discriminate in favour of its own retail operations and against its wholesale customers. It is noteworthy that BT has recently responded to the Ofcom proposal, demonstrating the incumbent's preparedness to engage with the regulator on this issue.

In the Australian context, there already exist models for distinctly identifying or 'ring-fencing' the monopoly and competitive activities of utility companies within the energy sector. Both the National Gas Code and mandatory guidelines issued by the Commission under the National Electricity Code contain ring-fencing provisions that have been in operation for some time.

Under these provisions, utilities are required to maintain separate legal entities for their internal business units. The separate businesses are required to allocate their costs in a reasonable manner, and are limited in the extent to which they can draw on common staff and share confidential customer information.

These arrangements do not preclude the separate businesses from being owned by the same shareholders, far from it, but they do improve the transparency and address underlying incentives to engage in discriminatory behaviour.

Let me be perfectly clear about this - the simple creation ('or beefing up') of a separate wholesale division within Telstra does not come close to addressing these issues. In order to provide a meaningful change, there needs to be an internal separation between a 'retail business' supplying services to end-users, and a 'network business' supplying wholesale services to both the Telstra retail business and those seeking access to its services so they can compete with Telstra's retail business.

In order to be effective, any process such as this would need to be underpinned with formalised arrangements, including requirements that the two businesses:

(1) deal with each other on a commercial, arms-length basis, including explicit transfer pricing, invoicing and billing;
(2) maintain fully separate accounts and reporting systems, capable of capturing all transactions between the businesses; and
(3) maintain separate staff at all levels, with staff remuneration tied exclusively to the performance of the relevant separated business.

Only measures along these lines will enable the Commission to develop a real-world understanding of the way that Telstra treats its wholesale customers relative to its own internal retail operations. Without it, too much is left open to speculation and debate.

Broadband – consumer take-up and Telstra competition notice

The past twelve months have seen an unprecedented surge in the number of people signing up to broadband services in Australia. The Commission has today released its latest *Broadband snapshot*, which reports that broadband take-up exceeded 1.5 million at the end of 2004. This is an impressive 120 per cent increase in the take up of broadband services in just 12 months. ADSL has emerged as the dominant broadband service, with over one million services now connected.

This rapid increase in broadband customers was clearly driven by the big and widespread price cuts that occurred across the sector last year. It also coincided with the Part A Competition Notice issued to Telstra in relation to the pricing of its wholesale and retail broadband services.

On 15 February 2004, Telstra announced significant price reductions for its retail broadband services without any reductions in its wholesale prices.

Following initial action by the Commission, Telstra reduced some prices for its wholesale services. However, as these reductions did not go far enough, the Commission issued a Competition Notice in March 2004, stating that Telstra has engaged, and was engaging, in anti-competitive conduct.

Following further subsequent reductions in Telstra's wholesale prices – the most recent of which came into effect at the start of this year – the Commission revoked the Competition Notice last month.

Whilst the extent of these wholesale price reductions would have varied between carriers, it generally cut wholesale rates by about a third.

The resolution of this matter also involved an agreement from Telstra to rebate $6.5 million to its wholesale customers; and the implementation of a notification protocol to prevent the recurrence of similar conduct in the future.

Importantly, the growth in DSL markets since the Competition Notice was issued has been shared by both Telstra and its wholesale competitors. Information available to the Commission through its *Broadband Snapshot* suggests that there was no significant long-term increase in Telstra's retail market share and would indicate that Telstra did not benefit directly from its conduct.

There has been some criticism of the Commission in recent weeks for not hitting Telstra with huge fines. I must say, with all due respect, such criticism misses the point.

I think all informed observers understand that the ACCC does not impose fines – they are ultimately imposed by the Federal Court upon application by the ACCC and after consideration of all relevant evidence.

In analysing the appropriate course of action for the Commission to pursue in relation to its Competition Notice, the Commission must take account of

- imputation analysis to determine whether an efficient competitor could compete across all broadband services – an inexact science in itself
- information and ultimately court admissible evidence from Telstra's competitors on their margins across broadband products
- legal advice
- the prospect of a protracted litigation process, including appeals, substantially delaying, potentially for many years, the final resolution of the dispute and the benefits that would flow to Telstra's wholesale customers

Taking account of all these factors, the Commission assessed the likely outcome of pursuing litigation against Telstra for the conduct that was the subject of the Competition Notice. The Commission had to weigh up the benefits gained by punishing Telstra versus getting compensation for those harmed by its action, and most importantly, protecting and promoting competition in broadband by ensuring this sort of conduct is not repeated.

After conducting an extensive analysis, the Commission considered the outcome achieved through negotiations with Telstra constituted a reasonable resolution of the issues that gave rise to the Competition Notice. However the Commission remains concerned at some weaknesses in the Competition Notice process revealed by this dispute.

In part, the weaknesses revealed were a direct result of the reluctance of many of those who were complaining loudest about Telstra's conduct to respond quickly when we asked for information and more particularly court admissible evidence. In this regard, the best jockeys were in the stands.

The imprecision of the imputation testing process to establish the appropriate commercial relationship between Telstra's wholesale and retail operations remains of concern. The Commission is working urgently to publish a set of principles as an adjunct to the notification process to give all participants in the market further guidance on its approach to price squeeze allegations.

More broadly, however, questions remain regarding the extent to which the regime acted as an incentive for Telstra to resolve the Competition Notice matter in a timely fashion.

Notwithstanding this concern, we consider that the process got us 70 or 80 per cent of the way towards a fully satisfactory outcome. However, we believe it has shown the Competition Notice arrangements can be improved to get more timely outcomes. The Commission is currently considering potential options for improving the process.

The Commission now intends to widen its broadband focus from the wholesale market to more sustainable forms of competition across the complete package of price, product and performance. One of the first steps in achieving this goal is ensuring effective access to the unbundled local loop service (or the ULLS) and the line sharing service (or the LSS), which will enable alternative and competing broadband networks to be used.

Broadband – access to the unbundled local loop and line sharing services

Since the ULLS was declared in 1999, rival telcos have predominantly used the service to compete with Telstra in the business markets in inner city areas. To compete for customers in the residential market, on the other hand, access seekers have largely relied on Telstra's wholesale ADSL service.

Broadband take up has now reached the point, however, where it is becoming increasingly viable for access seekers to roll-out their own DSL infrastructure into a larger number of Telstra's exchanges.

Increased infrastructure roll-out would allow competitors to provide a much higher quality, and more diverse range of broadband and other services than is possible by simply reselling the Telstra wholesale ADSL service. There is clear potential, for example, for full video services to be provided over DSL technologies. It is imperative, therefore, that Telstra's competitors have timely and efficient access to exchanges in order to enable them to roll-out services to the mass market.

A number of commentators have pointed out the potential for an incumbent to engage in non-price discrimination or 'sabotage' to kill off this competition before it even gets a foothold by, for example, raising the costs of accessing essential inputs.[2] The potential for sabotage is especially pertinent in light of recent concerns raised by competitors contemplating the mass roll-out of ULLS/LSS based services.

Some of these complaints raised directly with the Commission include the prospect of significant delays and associated costs in gaining access to Telstra exchanges. The Commission notes that the current ULLS provisioning processes are ill-suited to addressing these concerns within the context of a rapid mass-market DSLAM deployment.

To date, Telstra has been slow to improve processes to enable large-scale roll-outs and has not demonstrated a real commitment to changing its systems to meet these needs.

Our views in this regard appeared to be supported by comments attributed to the Telstra CEO at the time of Telstra's half-yearly results. According to the AFR of 14 February 2005, the CEO noted that Telstra had developed 'mitigating strategies' to address the increasing prospect that competitors will seek to roll-out their own DSL networks. This reference to 'mitigating strategies' could potentially be interpreted in a sinister fashion.

However Dr Switkowski has assured me that what Telstra had in mind was the launch of more attractive products for its wholesale customers. It remains to be seen which interpretation is ultimately proven to be the correct one.

I can assure you the Commission will not look lightly on any attempts by Telstra to impede or hinder competition, for example by slowing the roll-out of DSLAMs, and is prepared to deal accordingly with any such behaviour.

We are now actively considering a number of options available under the *Trade Practices Act* and our other powers to expedite industry outcomes.

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[2] See for example, David Mandy (2000), 'Killing the Goose that Laid the Golden Egg: Only the Data Knows Whether Sabotage Pays', *Journal of Regulatory Economics*, 17, pp.152-172 and the literature cited there.

As an initial step, the Commission will be moving to make variations to our *2003 Model Core Services Terms and Conditions Determination* for the ULLS (and also applying this to the LSS as appropriate). The Commission is of the view that setting out its position on a number of specific issues is likely to be an effective means of addressing some of these non-price concerns and sending a clear signal to Telstra. This action will also provide greater certainty for access seekers and facilitate the progress of commercial negotiations.

But at all times, the Commission remains ready to work with all industry participants in the development of more co-operative processes for accessing the local cooper loop.

Undertakings and increasing regulatory gaming

Also relevant to improving regulatory certainty over access to Telstra's local loop, the Commission has just this week released two discussion papers regarding the revised Telstra ULLS and LSS undertakings. The current undertakings follow the withdrawal of two earlier undertakings lodged in relation to the ULLS – going back as far as January 2003 – and the rejection of an earlier LSS undertaking, lodged with the Commission in September 2003.

This also follows the recent release of Commission discussion papers regarding the Vodafone and Optus undertakings in relation to the mobile terminating access service.

The Commission's consideration of these undertakings is well underway. However, on a broader level, there are disturbing signs that the undertaking process has become increasingly subject to regulatory game playing. In some cases, there have been lengthy delays between the lodgement of an undertaking and the provision of the supporting documentation. In others, undertakings have been lodged that are simply inconsistent with the underlying costing information. This type of behaviour does not appear to indicate a genuine commitment to the undertaking process, which is intended to achieve more timely industry outcomes.

It is important to note that the consideration of an undertaking need not stop the Commission in the meantime from conducting an arbitration, if required, and issuing an interim determination. In this regard, the undertakings currently before the Commission won't necessarily delay the consideration of current or potential access dispute notifications regarding the services in question.

Broadband – access to content

The other way to promote competition is by protecting the development of new technology that allows both existing players and new entrants to be able to develop competitive infrastructure.

It’s absolutely crucial that existing players not be allowed to use their market power to strangle at birth these new forms of competition, either by impeding them or buying up control of the market before it has even developed.

In the very near future most traditional methods of delivering news, entertainment, sporting and advertising content will be directly challenged. Increasingly, video and TV services will be provided together with internet and traditional telephone services as part of the ‘triple play’.

Crucial to the success of any ventures using these new technologies will be content rights, and in particular premium or “compelling” sporting content, such as AFL, rugby, rugby league, cricket, tennis, to name a few.

It is vital therefore that no single carrier acquires exclusive rights to all that content and effectively locks out the potential competition.

There is a risk that the exclusive acquisition of such rights for new and emerging markets like DSL broadband and 3G mobiles will allow the rights-holders to shut out competition across a range of services delivered over these new networks. Ultimately, this could deprive consumers of choice and quality not only for broadcasting, but also voice, internet and innovative services such as video calls and determine the success or failure of an entire competitor. As I said recently, if you can't control the arteries, what you do is get hold of the blood.

The *Trade Practices Act* has always recognised the potential for exclusive contracts to be anti-competitive. Section 45 of the Act prohibits companies from entering any contractual arrangements that result in a substantial lessening of competition. Section 47 of the Act is even more explicit: exclusive dealing that causes a substantial lessening of competition is illegal.

There is a whole range of processes that we are now looking at to ensure that doesn’t happen. We want to be sure that in an environment of new technology involving new competitive infrastructure, that a single dominant player doesn't have the capacity to stop that new competition at its birth.

In the early part of 2005, the Commission will be liaising with a range of interested industry and government organisations about these issues.

Conclusion

There’s a joke amongst quantum physicists that if you say you understand quantum physics, then it’s pretty clear you actually have no understanding whatsoever of quantum physics.

Looking at recent commentary in this country one might be tempted to argue the same point about telecommunications regulation.

But it’s actually pretty simple – for as long as one carrier overwhelmingly dominates the telecommunications sector, to the extent that all its competitors are beholden to it for access to the very infrastructure they need to compete,

then regulation will be required to ensure that, as far as possible, competition is protected.

As we showed with the broadband Competition Notice, this does not necessarily require that the dominant player be broken up, or even prevented from itself competing vigorously in the market place.

But what it does require is transparency, a willingness by all parties to work with the ACCC, and a strong and timely response when any action is taken to unfairly forestall that competition.