



**Australian Competition and
Consumer Commission**

Promoting Competition and Fair Trading

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Regulating Competition in the Telecommunications Market

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This conference comes at a crucial time for the telecommunications sector.

We are seeing emerging markets, networks and new technologies that all have the potential to offer some real competition in Australia's telecommunications markets.

Competition has not developed to the extent expected at the time the industry was substantially deregulated in 1997.

However technological developments offer the prospect of serious challenges to Telstra's dominance and opportunities for Telstra's competitors:

- Firstly, by lowering the costs of existing infrastructure, such as telephone exchange switchgear which improves the economic viability of competitive infrastructure; and
- Secondly, technology is improving the viability of new communications modes, such as fixed wireless and satellite.

But while technology may be the saviour of competition we must ensure this serious challenge to Telstra's current market power is not strangled at birth.

These emerging markets, networks and technologies will only survive if they are supported by effective regulation designed to promote sustainable competition in which competitors are less reliant on Telstra infrastructure.

So, the role of regulation and the ACCC must be, in the short term at least, to ensure operators are not unduly prevented from developing a customer base, while at the same time and with the longer term in mind, design and apply regulatory solutions that best promote competitive infrastructure.

That is why the Commission is focussed at present on promoting and protecting opportunities and incentives for the development of competitive infrastructure and services, including the deployment of new technologies on existing and refurbished

networks. This is particularly pertinent, given the increasing momentum in investment in the industry after several years of very sluggish growth.

New entrants need a reasonable opportunity to build new access networks, or to use existing networks to provide new services and technologies. This should be able to occur without the added burden of having to combat anti-competitive behaviour.

Before I warm to this theme any further – I will return to it later – I should reiterate that while the future holds a good deal of promise in terms of new networks and services, the recent past has not been so positive.

Current state of competition

The Commission's disappointment with the current state of competition within much of the telecommunications sector will be fairly well known to most of you.

This view – most recently articulated in our 2002-03 annual reports on competitive safeguards and price changes – has remained unchanged for a number of years now. Competition in telecommunications has developed unevenly across different regions and at different levels. Outside of central business districts and some metropolitan areas, widespread competition remains elusive.

The reasons for this are clear – Telstra is one of the most vertically-integrated telecommunications companies in the world. It continues to be the major wholesale supplier across the full range of telecommunications services, from fixed-line and mobile voice services, through to Internet services and pay TV.

Telstra's market power across these services provides it with the ability and, most importantly, the incentive, to impede entry into new and emerging markets.

It is not now, and never will be the aim of the Australian Competition and Consumer Commission to try to stop Telstra from competing vigorously in emerging markets nor legitimately exploiting its economies of scale and scope. What we do want however is to see more effective competition between Telstra and other providers in a way that provides their customers with better and more affordable services.

So while the recent past in the telecommunication sector has not been so positive, it's fair to say (very cautiously) that the future holds a good deal of promise in terms of new networks and services.

Broadband concerns

The Commission has today released its latest *Snapshot of Broadband Deployment*, which shows that as at March 2004 total broadband take-up stood at 829,300 services. This is an increase of 130,600 from December 2003 – the largest quarterly increase since the Commission began collecting these statistics in mid-2001.

This data illustrates not only the early stages of increased growth following the changes in pricing structures that began in February this year, but also the emerging nature of the take-up of broadband services in Australia more generally. It is

important to note, however, that growth in the broadband market does not necessarily mean that sustainable competition is improving.

Instead, this market provides a very good example of both the kind of opportunities and competition concerns that I wish to highlight to you today.

Telstra's ownership of both the copper access network that connects virtually every Australian home, and the largest HFC network in Australia provides it with effective control over the market for the delivery of downstream DSL and cable modem broadband services. Yet, despite being the retail broadband market leader, Telstra's share of this market has remained relatively low compared to the other services it offers.

Earlier this year, Telstra acted decisively to try to reverse this situation by slashing the price of its BigPond broadband service. Now, while it is entirely proper for Telstra to chase more customers by cutting prices, our very strong view is that Telstra's dominance over the local loop must not be used improperly to dominate the retail broadband market and squeeze out its competitors. Our recent actions in relation to the broadband competition notice should be seen in this light.

The notice was issued in March because Telstra's wholesale customers were being prevented from, or hindered in, supplying broadband services to retail customers at prices that enabled them to compete with Telstra.

In short, many complained the price they were being charged at the wholesale level by Telstra meant it was uneconomic for them to compete with Telstra's retail price.

As the Commission still has reason to believe that Telstra is engaging in anti-competitive conduct of the kind described in the notice, we have decided to keep the notice in force. Our analysis of Telstra's revised wholesale pricing structure – announced following the issuing of the competition notice – suggests that the revised pricing structure still has significant limitations. The evidence also suggests that these limitations are likely to substantially hinder the ability of Telstra's wholesale customers to compete with Telstra BigPond at the retail level.

The Commission has been allowing negotiations between Telstra and its wholesale customers and retail competitors to take place while gathering evidence to assess the effect upon competition of Telstra's pricing. Clearly, the question of what further action the ACCC should take requires a different level of evidence than that required to issue a competition notice or consider revocation. At present, the ACCC remains of the view that Telstra's pricing is likely to result in significant anti-competitive effects.

To decide if further action needs to be taken, the ACCC will be moving quickly to gather further evidence which can be presented in court, if necessary, and expects those access seekers whose complaints prompted our initial action, to be just as forthcoming in this regard. When determining what should be done after obtaining this material, the ACCC will need to be conscious of the way the conduct would affect competition in the broadband market.

The Commission notes that the stifling of competition, especially at the entry or lower speed level of the market, has the potential to shut out long term competition at an important stage of broadband growth in Australia. This would make it more difficult for broadband competitors to, in time, use Telstra's local loop directly with their own DSL infrastructure to provide a wider and sophisticated range of broadband offerings and be able to compete on a more sustainable basis; that is, with less reliance on Telstra infrastructure. Equally, such anti-competitive actions could impede the development of new efficient technologies and their ability to provide broadband services, such as wireless networks.

We are as concerned about the longer term and more fundamental competition issues surrounding competitive infrastructure arising from Telstra's conduct as we are with the shorter term implications for wholesale broadband services themselves. In the absence of competitive infrastructure (or effective competition at the retail level), prices can languish. ISDN provides a good example of where this continues to be the case.

There is a continued need to assess the current state of broadband competition in the light of the revised Telstra plans both in terms of its current intensity and the implications for more sustainable competitive outcomes.

As I noted in a recent presentation to SPAN, balancing short-term considerations and longer-term considerations in relation to competitive process is not an easy task. On the one hand cheaper prices will drive growth in the number of broadband customers, as the figures I released today would confirm, but if those price cuts drive competitors out of the market, this may not be in the best long term interest of the broadband sector.

Achieving the right balance between promoting broadband competition at the retail level without diminishing the commercial viability of facilities-based competition is an ongoing challenge for regulators around the world. Recent statements by Ofcom and the European Union have stressed the inter-dependencies between service and facilities-based approaches and the Commission shares these sentiments.¹

Both the wholesale provision of services and access regulation itself derives from recognition that, in many instances, competition is not viable in all areas at this time, and in some areas it may not be viable for a long time, if at all

There are multiple roles for wholesale, access-based and facilities-based competition and the Commission sees these different levels of competition continuing under the current regulatory regime. Carriers and service providers will use a differing combination of their own and other carriers' facilities and services, depending on the nature of the services, the geographic markets and the customers they are targeting and their scale of operations.

¹ Refer: *Ofcom's Broadband Framework*, Stephen Carter speech at Ofcom, 13 May 2004; and *Competition and regulation in the telecom industry – the way forward*, speech by Mario Monti the European Competitive Telecommunications Association Conference in Brussels, 10 December 2003.

To date, the focus of access regulation in broadband services has been on the key network inputs essential to the provision of DSL services. In doing so, the Commission has sought to provide the opportunity for efficient access-based providers to switch to other services where appropriate. This work has included the declaration of the unbundled local loop service (ULLS) in 1999 and the Line Sharing Service (LSS) in 2002 and associated work to establish pricing principles for these services. The take up of the ULLS and particularly the LSS has remained low to date, although there have been encouraging signs more recently. In part, low take up rates have reflected difficulties in pricing and the Commission will continue to work towards ensuring the service is available at prices that make efficient investment in DSLAMs viable.

In seeking to obtain the right regulatory balance, the Commission has been cautious about regulating end-to-end wholesale broadband services under the telecommunications access regime contained in the Trade Practices Act. We are mindful that doing so could result in long-term regulatory dependence that may stifle or delay the move towards more sustainable long-term competition. Rather, the Commission has relied on the competition provisions of the Act to address anti-competitive concerns in wholesale broadband markets as they have arisen. We will continue to monitor the effectiveness of this approach in light of future industry developments and cannot rule out the need for a more direct regulatory approach.

Telstra's undertakings

This brings me to the Commission's current consideration of undertakings that have been submitted by Telstra which have a direct bearing on achieving more sustainable competitive outcomes in broadband services.

The Commission recently released its draft decision to reject Telstra's LSS access undertaking which proposed a price of \$15 per line month. We also have concerns with some of the non-price elements of the undertaking, particularly in relation to the way the undertaking may have operated to preclude the supply of the LSS declared service outside the undertaking process.

The main consideration in rejecting the proposed \$15 price concerns the level of expected demand for this service, given that the price is derived by dividing the annualised cost associated with Telstra's provision of LSS amongst all access seekers. No other costs, such as line costs, are taken into account. Assuming an unduly low demand will mean a very high unit cost (thereby supporting a higher charge) which will continue to dampen demand.

The Commission recognises that the monthly price of LSS is not the only factor that access seekers need to consider in rolling out their DSL infrastructure into exchanges. However, what we are concerned about is ensuring that prices are broadly reflective of the underlying costs so that the build-buy decisions of access seekers are more efficient, making the facilities-based option a more viable one. The draft report regarding the LSS undertaking is currently out for public comment.

In relation to ULLS, as many of you will know, this service provides much greater flexibility to competitors to use Telstra local loop network to provide a wide variety

of broadband, data, multi-media and voice services, largely independently of Telstra. We see this as akin to a facilities based approach where only Telstra's twisted pair (the network element subject to the strongest bottleneck constraints) is being utilised by service providers.

In our indicative pricing determination in October last year we suggested prices for monthly access of between \$13 and \$22 in CBD and metro areas – the areas where DSL technologies are most used. Telstra submitted revised undertakings consistent with these rates shortly thereafter.

We have been considering these rates and have sought comment from industry. One key concern appears to be the mechanism which Telstra has proposed to deal with fluctuations in demand. For example, under the Telstra proposal, where demand is less than that projected under our aspirational approach, the charge increases by a specified amount and vice versa. If there is sluggish growth in the early years of the roll-out of ULLS services, this means an increasing charge, which will have an effect on the incentive for early take-up. At a more practical level, it would be of particular concern to have the prices proposed by Telstra in its ULLS undertaking changed to reflect 2002-03 demand outcomes before the undertaking has come into effect. We have sought input from Telstra in relation to this issue.

This also explains some delays in the Commission's consideration of these core service undertakings (which also include assessment of PSTN interconnect and local carriage services - LCS) given a number of new issues which have arisen and the time it has taken for submissions and further input to be made by interested parties.

In this regard, I should note that our further analysis of the detail of the PSTN undertakings submitted by Telstra – and particularly the disaggregated rate table – suggests that these have been derived by the use of questionable traffic and call assumptions, which has led to average rates which are clearly above those of our model prices determination released last year. Notwithstanding any agreements that may have been made on a commercial basis, there may well be very real issues with the undertakings, which we would expect to be at least truly reflective of upper-bound rates as indicated in our model price determination.

That said, the conclusion of individual agreements does not in any way remove the need for the Commission to form a view on the current undertakings. We anticipate finalising our views on this matter shortly.

Impact of new delivery platforms, technologies and services on competition

So while the recent past in the telecommunication sector has not been so positive, it's fair to say the future holds some promise in terms of new networks and services.

The Commission is focussed at present on promoting and protecting opportunities and incentives for the development of competitive infrastructure and services, including the deployment of new technologies on existing and refurbished networks. This is particularly pertinent, given the increasing momentum in investment in the industry after several years of very sluggish growth. The new investment we are seeing is fortunately being focussed on the deployment of new access networks based on

wireless technologies as well as the provision of services using new IP-based technologies on existing networks.

In relation to wireless developments, operators are currently in the process of deploying networks in areas of metropolitan Sydney – and have also signalled their intention to ultimately expand these networks to cover between 75 and 95 per cent of the Australian population over the coming years.

Networks of this type generally involve infrastructure investment on a smaller scale than the fixed networks and have greater scope to achieve efficient scale. Importantly, these networks are not reliant on Telstra's copper and cable networks in order to gain access to customers. If new networks gain sufficient traction, they can certainly provide a real competitive challenge to existing networks and thereby provide the kind of competitive impetus in services such as broadband that I spoke of earlier.

The extent to which this ultimately occurs remains to be seen. However the Commission will be particularly vigilant in examining any conduct that impedes efficient network deployment by these new operators.

New entrants need a reasonable opportunity to build new access networks, or to use existing networks to provide new services and technologies. This should be able to occur without the added burden of having to combat anti-competitive behaviour.

In looking at the Commission's recent decisions and actions, therefore, much of this has been informed by the need to promote and protect opportunities and incentives for the development of competitive infrastructure and services, including the deployment of new technologies on existing and refurbished networks.

Related to this is the importance of providing sufficient spectrum to allow the deployment of various wireless technologies that can be used to provide broadband services. In this context, I note that the ACA is currently reviewing the use of spectrum capacity which could be deployed by such networks in the future. It is important to note that a scarcity of available spectrum can constitute an absolute barrier to entry into this market.

Another promising area of development is the move towards the provision of new services using new IP-based technologies on existing networks.

This process continues to be an evolutionary one, involving the transition from circuit-switched to packet-based technologies. From a market structure perspective, one significant change accompanying this transition is likely to be the increasing decoupling of user applications from the underlying network services that are used to deliver them. This has potential to disrupt some of the existing market structures that currently flow on from the incumbent's control of the underlying network infrastructure.

The provision of voice over IP services on existing networks provides one example of where Telstra's dominance over the provision of basic voice services is likely to be increasingly challenged over time. Ultimately, the provision of voice, text and data

services over new next generation networks could afford even greater opportunities for the development of more broadly based competition.

The future sources of market power that will evolve with the full development of IP services remain to be seen – they may remain in the physical network or could potentially shift to higher levels of applications-based service provision. Again, as with the further development of wireless networks, the competitive potential of new technologies on existing networks will also be influenced by how existing network owners respond and whether their actions are designed to unfairly stymie the competitive potential of these services.

The Commission will remain vigilant about any such conduct and, more broadly, will be looking further in the coming year at the nature and scope of access regulation of new services to ensure it remains effective, measured and proportionate.

In doing so, we will aim to minimise regulatory action wherever this is feasible – while ensuring that any necessary regulation is timely, efficient and effective.

More generally, the Commission will be carefully watching these developments to ensure that such technologies are able to be deployed effectively and lead to more efficient outcomes for end-users.

Mobile termination access service

I would like to conclude with a brief discussion of the Commission's recent decision regarding the mobile terminating access service – as this decision is both topical and has particular relevance to many of the issues that I have raised here today.

As most of you would be aware, the Commission decided to continue the regulation of this wholesale service (which is provided by mobile operators for terminating calls made to subscribers on their networks, including both fixed-to-mobile (FTM) and mobile-to-mobile (MTM) calls).

The decision also introduces a more direct pricing principle, which is designed to achieve a closer association between the price and the underlying cost of the service. In reaching its decision, the Commission found that the existing termination price (of around 22.5 cents per minute, on average) is more than double the cost of delivering the service. To redress this imbalance, the new price-related terms and conditions indicate the price should to fall to 12 cents per minute by the start of 2007 – commencing with an immediate reduction to 21 cents and continuing with further reductions of three cents per minute at the start of each of the following three years.

As part of its investigations, the Commission found that the above-cost pricing practice of mobile operators was having a negative impact on competition in the market for fixed-line services.

To illustrate with one example, above-cost prices enable vertically-integrated operators (those owning both fixed and mobile networks) to increase the FTM costs of their rivals while maintaining lower costs when terminating FTM calls made from their own fixed networks on their own mobile networks. In the case of Telstra (which

has around 45 per cent of the mobile market), this means that around 45 per cent of its FTM calls can be provided at a significantly lower cost.

In contrast, fixed-line competitors without a mobile network have no option other than to pay the full termination price for all of their FTM calls. Our analysis indicates that these providers pay somewhere between 10.5 and 17.5 cents per minute more than Telstra does when terminating calls on the Telstra network. Clearly this results in a significant distortion of competitive processes, as it provides Telstra with a significant cost advantage over its FTM competitors.

The Commission's decision will help to remove this cost advantage and promote more efficient use of infrastructure, as the ability of vertically-integrated and mobile operators to raise the costs of their rivals will be substantially diminished.

In this context, it has been somewhat perplexing to see recent media statements that the Commission's decision will result in a so-called 'windfall gain' for Telstra of up to \$100 million in the 2004-05 financial year.

These statements are based on the questionable assumptions that Telstra sends more FTM calls than it receives – and that Telstra will not reduce the retail prices of its FTM calls.

It is worth reflecting on the second assumption for a few minutes.

In the first instance, it is highly likely that Telstra's rivals will seek to take advantage of the new reduced wholesale prices and pass most or all of the input cost reductions onto end users in order to win a greater share of the market. There are signs that this is already starting to occur, with AAPT and Macquarie Corporate recently declaring their intentions to reduce the retail prices of FTM calls. In light of these reductions in retail FTM prices, Telstra will be faced with the choice of making similar changes to its prices or losing market share to its rivals. In these circumstances, it is difficult to see how competitive forces will not result in Telstra passing most or all of the wholesale price reduction through to its fixed-line customers.

Our analysis indicates that Telstra would only need to pass 50 per cent of the wholesale price reductions through to its customers for it to be worse off in revenue terms. As such, it is unclear how the recent decision will result in a 'windfall gain' for Telstra. On the contrary, one of the key aims of the decision was to promote competition in the fixed-line market. In having the largest share of this market, Telstra clearly has much to lose from the decision.

Overall, the Commission is confident that the decreases in mobile termination prices will promote the long-term interests of phone users. Among other things, it will significantly improve the state of competition in fixed-line markets and, by doing so, lead to significant reductions in the price of fixed-line services in years to come.

Importantly, the decision also effectively removes a potential disincentive to the roll-out of some of the emerging networks and services that I referred to earlier. For example, without the new pricing principle, wireless operators contemplating the roll-out of voice over IP services would need to factor in the impact of FTM costs

significantly higher than those faced by the vertically-integrated operators. Clearly this would not be in the best interests of a competitive and dynamic telecommunications market.

Looking forward, our work will continue to be informed by the need to promote and protect incentives for the development of competitive infrastructure and services, including the deployment of some of the new networks and technologies that I have touched on briefly today.

Thank you.