



CHALLENGES IN TELECOMMUNICATIONS COMPETITION AND REGULATION

SPAN

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ED WILLETT - COMMISSIONER

Ladies and gentlemen,

The Commission's disappointment with the current state of competition within much of the telecommunications sector will be well known to most of you. This disappointment was made clear in our annual report on Competitive Safeguards and price changes released by the Minister late last week. As you would be well aware, this assessment has been unchanged for some years now.

Today, I want to start with a general overview, before illustrating the concerns we have by focussing on one particular area of the market that has been much in the news of late, broadband.

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 – the continuing dominance of virtually all areas of the telecommunications market by Telstra.

Telstra is one of the most integrated telecommunications companies in the world, continuing to be the major wholesale and retail supplier of telecommunications services, including:

- local, national, long distance, international and mobile telephony
- dial-up and broadband internet
- pay TV (through its 50 per cent ownership of Foxtel).

Market power across these markets provides Telstra with the ability and, most importantly, the incentive, to impede entry into new and emerging markets.

I should emphasise that in highlighting our concerns over the existing structure of the industry, our aim is not to try to stop Telstra from competing vigorously in emerging markets nor legitimately exploiting the economies of scale and scope it brings to these markets. What we want to see is both Telstra and other providers competing more effectively with each other and in so doing providing their customers with better and more affordable services.

Broadband concerns

Broadband is one significant emerging market that is a good example of the kind of competition concerns that I wish to highlight to you.

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. The Commission is mindful that Telstra's dominance over the local loop should not be leveraged improperly to dominate the retail broadband market and, potentially and importantly, to preclude future facilities-based competition.

The recent focus in broadband competition has been squarely on the wholesale market, largely as a result of the competition notice imposed on Telstra by the Commission. The competition notice was issued 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 the medium-long term.

The Commission also noted that the stifling of competition in retail service provision, especially at the entry level of the market, has the potential to foreclose more sustainable facilities-based 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. We are as concerned about the longer term and more fundamental competition concerns arising from Telstra's conduct as we are with the shorter term implications for wholesale broadband services.

The competition notice remains in force. There are a number of potential options open to the Commission in relation to the notice and these are currently under consideration.

One thing the Commission is mindful about, however, is achieving the right balance between promoting broadband competition at the retail level without diminishing the commercial viability of facilities-based competition. This challenge is not unique to Australia – regulators worldwide are currently grappling with similar issues.

In a recent speech on Ofcom's broadband framework, its CEO, Stephen Carter stressed the interdependence of service and facilities-based competition in achieving sustainable and long-term competition.¹ He highlighted the importance of access or service-based competition (known as Datastream in the UK – which is broadly similar to Telstra's layer 2 or 3 wholesale product) in achieving competitive outcomes in specific areas and enabling some operators to build sufficient customer volume to facilitate their transition to the provision of broadband services using unbundled local loop services. Equally, Carter stressed the importance of reducing service-based regulation in areas where there is evidence of the emergence of competition at the local loop level. Such thinking also resonates quite closely with our own views.

Mario Monti, EU Commissioner for Competition Policy, expressed similar views late last year, stressing that there was not necessarily a contradiction between access or service-based competition on one hand and facilities-based competition on the other.² He also pointed to the fact that new entrants would be unlikely to enter the market without first purchasing access services from the incumbent and gaining a customer base. The key challenge for a regulator, therefore, is to develop a framework that

¹ *Ofcom's Broadband Framework*, Stephen Carter speech at Ofcom, 13 May 2004.

² *Competition and regulation in the telecom industry – the way forward*, speech by Mario Monti at the European Competitive Telecommunications Association conference in Brussels, 10 December 2003.

provides incentives for competitors to seek access to a fuller set of services over the shorter term while also providing incentives for these competitors to build their own infrastructure and rely less on the incumbent over the longer term.

These comments are just as relevant to Australia. The Commission agrees that service-based competition will be an important part of – as well as a precursor to – greater facilities based competition in the longer term. Both the wholesale provision of services and access regulation itself derives from a recognition that, in many instances, full facilities-based competition is not viable in all areas at this time, and in some areas it may not be viable for some time.

Reflecting on the multiple roles for wholesale, access-based and facilities-based competition, the Commission envisages a continuum of these different types of competition under the current regulatory regime. In practice, carriers and service providers will use a differing combination of their own and other carrier's facilities and services, depending on the nature of the services, the geographic markets and the customers they are targeting and their scale of operations.

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 transit 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. Other related initiatives include the release of model price terms and conditions late last year and the issuing of two record keeping rules in relation to the ULLS in 2001. The take up of the ULLS and particularly LSS service has remained low to date. In part, this has 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 of 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 any future industry developments in this area and cannot rule out the need for a more direct regulatory approach to this service.

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 has just 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, and 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.

To break this vicious circle, the Commission has taken a pricing approach which mirrors much of the behaviour in the retail market. We have assumed, for example, that the proportion of DSL broadband lines which will be supplied by LSS will be only slightly higher in Australia by 2006-07 – at just 4% of DSL broadband lines – than they were in EU countries on average in 2003 (3%). Even with such a modest uptake, and some minor re-adjustment of cost assumptions, we cannot justify a monthly charge per line of more than \$8 and indeed our analysis suggests a range of \$7-\$8 depending on whether one assumes a 4% or 5% LSS penetration target in three years to 2006-07. This also happens to be quite close to current EU averages for LSS monthly charges.

I should also add that while our estimates are around half of what Telstra is proposing, they are essentially based on Telstra's historical cost modelling, which has involved only minor adjustments. We have not undertaken a full audit of these costs to ensure they reflect optimised investment outcomes.

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 and does not expect a huge uptake even at a price of \$7-\$8. However, what the Commission is 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.

In relation to ULLS, as many of you will know, this 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 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.

On current time-frames, the core service undertakings are required to be finalised by October although we will hopefully finalise our processes prior to that.

Impact of new services/technologies and delivery platforms on competition

The second major (and indeed closely related) issue I wish to touch on today is the increasing momentum in investment in the industry after several years of very sluggish growth and investment. The new investment we are seeing is fortunately being focussed on the provision of services using new IP-based technologies on existing networks as well as the deployment of completely new access networks based on wireless technologies.

These are potentially significant developments in promoting competition of the broader telecommunication, IT and media industries over time. If these new services gain sufficient traction, they can certainly provide a real competitive threat to existing networks and thereby provide the kind of competitive impetus in services such as broadband and voice that I spoke about earlier. For that reason, the Commission will be particularly vigilant in stopping any conduct by powerful incumbents aimed at styming the efficient development of such services.

Equally, however, as regulators, we also need to ensure that our current telecommunications regime does not impose any undue burdens on providers of such services which unreasonably raises entry costs. Indeed, if the current regime is having such an effect, it may be time it was reviewed to ensure it accorded with the new environment.

New commissioners

The Treasurer recently announced the appointment of two new Commissioners, with Dr Stephen King and Mr David Smith both appointed for five-year terms.

You may be interested in how these recent developments affect the management of telecommunications issues within the Commission.

In effect, all Commissioners – not just those on the Telecommunications Committee of which I am Chair – are ultimately responsible for decisions regarding telecommunications matters. Clearly Stephen King and David Smith are both now integral parts of that process.

David Smith has also joined Graeme Samuel, Louise Sylvan and myself on the Telecommunications Committee. The role of this committee is to consider telecommunications matters prior to the decision-making process, enabling early analysis of issues and for initial feedback to be provided to staff, where appropriate.

The Commission takes a collegiate approach to its role and there is no single ‘portfolio’ Commissioner responsible for telecommunications matters.

However, as the Chair of the committee, I will continue to take a particular interest in the issues that come before it and provide the ‘public face’ on many telecommunications issues – both in terms of its public relations activities, such as this presentation today, and its meetings with outside parties.

I have no doubt that I will continue to interact with many of you in this capacity over the course of 2004 and beyond.

Thank you.