



## Australian Telecommunications Summit Sydney

### Update on recent regulatory developments in the telecommunications market

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Ed Willett, Commissioner

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With the Commonwealth committed to the sale of its remaining stake in Telstra, settling on a regulatory regime for Australia's telecommunications sector is now coming to a head.

As with most debates about infrastructure regulation, the focus has been on ensuring that we have underlying regulatory settings that continue to promote competition, whilst providing incentives for efficient investment in telecommunications infrastructure in the future. But more recently, the debate has moved on from these broader issues to proposals for more regulatory reform, such as the concept of operational separation and ensuring the effectiveness of the telco access regime.

As the body charged with regulating telecommunications in Australia, the ACCC has a major stake in this debate, and much to contribute to it. In telecommunications, we have seen the regulatory regime applying to the industry evolve and with some good outcomes. Nevertheless, there is still room for improvement.

#### **Effectiveness of the current regulatory regime**

Significant competition in telecommunications only began in 1997, but in the time since then, few would dispute the benefits that have flowed to consumers, business, and more broadly the Australian economy.

The initial benefits of the current telecommunications regulatory regime were almost entirely due to competitors entering at the retail level and making use of regulated interconnection to drive down retail costs. While there have been some areas of relatively robust competition - such as in corporate markets and mobile services - it is still somewhat patchy in terms of service offerings and geographic reach, particularly for residential consumers.

It's no coincidence that the more competitive markets are those in which competitors have built their own networks, rather than just reselling space on Telstra lines. For example, corporate and business customers have benefited to a much greater extent than residential customers, by virtue of infrastructure roll-out by newer players. Similarly, the development of competing mobile networks has created a structure for more sustainable competition in this area

of telecommunications. And where there is more sustainable competition there is also substantially less regulation.

But the overriding issue remains the absolute dominance of the telecommunications sector by just one player - Telstra - by virtue of it being the sole provider of the ubiquitous local access network connecting virtually every home and business in the country. This monopoly means that even in the more competitive markets, those seeking to compete with Telstra often must continue to rely on Telstra for some form of access to its network. This leaves those seeking to compete with Telstra with just two alternatives - either re-selling its services, or bypassing some or all of its network by investing in competing infrastructure.

Indeed, some industry commentators have said that Telstra is too big to regulate, given that it operates in almost every wholesale and retail telecommunications market. I wouldn't agree with this sentiment entirely - regulation of a monopoly infrastructure provider is always necessary – but Telstra's control of the wholesale inputs for the entire telecommunications market, coupled with the fact it then competes in retail markets, does create regulatory challenges, to put it mildly. This is precisely why the ACCC has highlighted aspects of the regulatory regime that could be changed to allow efficient competitors to compete with Telstra on a level playing field in those markets.

If we have a regulatory framework that establishes clear and verifiable legal obligations that are supported by robust enforcement mechanisms, more sustainable competition and efficient investment in telecommunications is possible. The ACCC believes this goal would be best served by creating an unambiguous 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 its competitors.

### **Operational separation**

The federal government is committed to a regulatory regime that will promote competition, encourage investment, and protect consumers. Increasing transparency about the way that Telstra operates its business is fundamental in achieving this objective.

The ACCC has previously highlighted its concerns that the enhanced accounting separation arrangements that were introduced in 2002 have not succeeded in giving the ACCC a satisfactory handle on the way that Telstra operates its business, and the ACCC is wary of relying on a 'second set of books' that bears no relationship to actual costs or implied revenues within Telstra.

In practice, accounting separation does not require Telstra to reorganise its arrangements as if it were operating two or more discrete businesses.

This is essentially what “operational separation” would entail. In turn, operational separation would provide a superior means of detecting and fixing anti-competitive behaviour.

The Minister for Communications, Senator Coonan, recently confirmed that the Government is committed to introducing operational separation of Telstra. And just last week, the Deputy Prime Minister Mark Vaile endorsed his predecessor’s call for a ‘genuine and robust’ separation of Telstra’s wholesale and retail units.

But there are different views about what operational separation, as it might apply to Telstra, actually means. This is especially the case since the UK telecommunications regulator agreed on a model for operational separation with British Telecom.

In her speech to the Adelaide Press Club earlier this month, the Minister Senator Coonan outlined the following key objectives for operational separation of Telstra:

- It should provide wholesale customers of Telstra with greater certainty and clarity of Telstra’s operations
- It should also give them confidence that they will receive the same treatment from Telstra Wholesale as equivalent to that provided to Telstra’s own retail arms
- It should allow the regulator to more quickly and effectively scrutinise Telstra’s activity and compliance with its regulatory obligations
- It should provide Telstra itself with greater regulatory certainty

The ACCC agrees that the objectives of certainty, clarity, equivalence, transparency and timeliness of regulatory outcomes underpin the case for operational separation.

### **Elements of an effective Operational Separation framework**

Earlier, I mentioned the limitations of the accounting separation rules. At the moment, accounting separation is really just a nominal form of regulation. It only requires Telstra to collect and report information about its price and non-price treatment of its wholesale customers relative to its own downstream operations. The information provided by Telstra under these arrangements is highly aggregated, which can hide specific instances of anti-competitive behaviour which would require more detailed analysis.

Internal separation between a ‘retail business’ supplying services to end-users, and a ‘network business’ that would supply wholesale services to all third party access seekers, would enable third parties to obtain prices and service levels that are effectively equivalent to those that are provided to the Telstra retail business.

The key principles that are necessary for robust operational separation are that the separated units must:

- deal with each other on a commercial, arms-length basis, including explicit pricing, invoicing and billing;
- maintain fully separate accounts and reporting systems, capable of capturing all transactions between the businesses; and
- maintain separate management and staff.

Genuine arms-length trading arrangements that deal equally with all retailers, whether they be from Telstra or a competitor, would provide Telstra's network business with stronger incentives to drive a hard bargain in maximising returns from all its activities, rather than favouring its own retail business. In a similar way, the Telstra retail unit would face the same commercial pressures as its competitors to procure its wholesale services.

Increased transparency from separate accounts also increases the likelihood of anti-competitive conduct being detected and punished. This should in turn act as a deterrent by reducing the incentives for Telstra to engage in such behaviour in the first place.

There is no reason for such a regime to hurt Telstra or its shareholders by adding to its costs. A network business and a retail business are fundamentally different, and an understanding of the costs and relative value of each component should assist management in extracting the maximum value out of the company as a whole.

As I'm sure you are all aware, these very issues were recently negotiated in the United Kingdom, with BT's operational separation undertakings to Ofcom. The basic elements of BT's undertakings involve BT committing to deliver equivalence of access to its wholesale customers by establishing a separate Access Services Division, and a separate wholesale division, as well as addressing other issues.

At a time when we are considering the prospects of operational separation in Australia, comparisons to the UK model are to be expected. But any reforms to the Australian regime must reflect our own regulatory history, circumstances and environment. From the ACCC's perspective, meaningful Operational Separation for Telstra would involve, at minimum:

- Robust separation of key business units – rather than theoretical commitments to provide equivalence, competition would be enhanced with a structure that provides clear incentives for Telstra to engage in competitive arms-length dealings;
- Equivalent, though not necessarily equal prices – there may be instances where there is an openly justified and verifiable reason for Telstra's prices to be different to those of its customers;
- Appropriate coverage of monopoly services provided by Telstra;

- Durability – rather than be based on a static view of market and industry structures, the framework should be able to accommodate emerging bottlenecks;
- Appropriate interplay with the competition and access provisions of Parts XIB and XIC of the *Trade Practices Act*. In some cases, appropriate operational separation might mean that some regulation could potentially be relaxed; and
- Finally, all of this should be underpinned by enforceable governance arrangements.

### **Benefits of meaningful operational separation**

The ACCC sees operational separation as an important reform that would weaken Telstra's incentives to engage in anti-competitive conduct that would normally require enforcement under Part XIB of the Trade Practices Act. It would also enable more timely resolution of access disputes arising under Part XIC.

Operational separation would achieve this by making highly transparent both the price and non-price terms and conditions upon which Telstra supplies its services. To use a broad example, if the prices Telstra is selling network services to itself are substantially lower than those it charges competitors, the ACCC will be able to much more quickly take action, by either issuing a Competition Notice, as we did in the Broadband dispute, or amending indicative access prices. In reaching such decisions, the quality of the information will be much more robust, as network and retail costs will be in separate accounting systems, and will be less amenable to cost shifting. This would also allow the ACCC to respond more quickly.

If network access prices are simply too high – for Telstra retail as well as its competitors - then over time this will reveal itself in lower profitability of Telstra's retail unit, and again, the ACCC will have a stronger basis for issuing new indicative access prices under Part XIC.

I also mentioned the appropriate scope of an operational separation model. Another key objective of operational separation is to ensure that market power associated with key bottleneck services is not easily leveraged into downstream markets. Even if this objective is achieved to an acceptable extent, it does not address the basic issue of monopoly power in network services. Ultimately, the goal of operational separation is to put Telstra's downstream units into a position that is roughly equivalent to that of competitors who don't enjoy the same benefits that come with vertical integration. As such, there is a clear efficiency rationale for continued regulation of bottleneck services.

As I already noted, increased separation and transparency would themselves weaken the incentives for Telstra's network/wholesale unit to engage in discriminatory behaviour. A further advantage to Telstra, though, is that

operational separation would carry substantial evidentiary weight in a court's consideration of any matters brought before it. In this regard, operational separation should provide Telstra with an increased confidence that its conduct is acceptable, and provide it with increased regulatory certainty.

### **Focused regulation**

The ACCC has always held the view that regulation should target those areas which are least likely to be competitive, and that it should be progressively withdrawn from those areas which can support sustainable competition.

Effective operational separation would therefore give the ACCC cause to review Telstra's current reporting obligations. There may be scope to wind back some aspects of the current accounting separation arrangements. Most importantly, it may also increase the ACCC's capacity to reduce its regulatory interventions.

To date, the bulk of the ACCC's activities in telecommunications have been directed towards ensuring that competitors are able to get access to the copper network, where they need it, at reasonable prices and on reasonable terms. By this I mean that they can buy wholesale services from Telstra at prices that still allow them to compete at the retail level. These wholesale services might be a straight re-sale of Telstra's offerings, or competitors might want to use only some parts of the copper network, for example, the local access networks that run from the exchanges to customers' premises.

To this end we have a role in arbitrating disputes when parties are trying to get access to critical parts of the network. We assess undertakings about the terms and conditions on which that access is provided, we collect a whole range of accounting information about the costs, revenues and volumes, and even look at measures of the comparative quality of services that are provided to internal and external customers. And when there is a seriously anti-competitive act, we can respond quickly by issuing a Competition Notice which says in the clearest possible terms "this conduct is unacceptable".

Some of the mechanisms available to us are reasonably effective, some less so. Access regulation does provide better incentives for infrastructure owners to reach commercial agreements with those seeking to use the infrastructure, but it can be a lengthy process, and subject to game-playing.

### **Improving the timeliness and effectiveness of access decisions**

It is therefore in the interest of all of us then to develop an access regime that encourages timely and effective regulatory outcomes. However, the ACCC is concerned that the current regulatory framework enables access providers to use undertakings in a strategic way to delay and prolong regulatory outcomes. From our perspective, delays are not consistent with the policy objective of

timely regulatory decision making, and do nothing to reduce uncertainty around regulatory issues.

The key regulatory instruments for ensuring efficient access to networks are in place - access undertakings have the potential to achieve desired outcomes by setting out terms and conditions that can be workable for all users, and the ACCC's arbitration powers are an important tool in resolving access issues and disputes. However, the experience of the past three years or so has shown that the processes for promoting efficient access are often frustrated by providers who seek to game the process by submitting undertakings that don't have reasonable prospects of being accepted, and consequently delay the arbitration of an access dispute.

I would strongly support a review of those elements of the regulatory regime that encourage this unhelpful behaviour. There are aspects of the regime that would benefit from further clarification, such as the interplay between arbitration processes and access undertaking applications, and whether the ACCC should prioritise one process over the other. The ACCC is also interested in streamlining the arbitrations process by encouraging faster interim determinations.

In making these recommendations, the aim is not merely to improve the ACCC's ability to settle disputes more quickly, important as that is. The ACCC would like to be able to use the arbitration powers more selectively, and encourage undertakings that would apply on an industry-wide basis, in keeping with the original policy intentions.

Clarification of the ACCC's processes for issuing arbitration determinations and undertaking decisions, and its ability to make faster interim determinations, would reduce the incentives for an access provider to delay the dispute resolution process. Ultimately, this will enable greater clarity of the ACCC's role and powers, facilitate more timely decision making, and increase regulatory certainty for all players in the telecommunications market.

## **Conclusion**

Sustainable competition in telecommunications is critical to making Australia an internationally competitive economy. There is virtually no area of Australian business and social life that is not impacted by the cost and service standards in telecommunications. The importance of telecommunications services to the overall economy is likely to increase with the adoption of emerging technologies.

It's clear that since deregulation we have come a long way – we have much better services, cheaper prices, and in some areas such as mobile and business services, there are signs that effective competition is emerging.

But what is just as clear is that in many other areas of telecommunications, such as fixed line services, competition has not emerged to the extent we had hoped for, even just a few years ago.

With the increasing dependence on the fixed copper line for high speed broadband, and the slow roll out of facilities based competition in many areas, it is clear that effective and appropriately focused regulation will continue to be necessary to ensure competition develops in telecommunications.

Ensuring that there is an effective access regime, which is not susceptible to gaming, takes on even greater importance in the absence of effective operational separation. An effective access regime becomes the critical tool for ensuring that competitors can gain cost-based, non-discriminatory access to telecommunications networks, but meaningful operational separation will go a long way toward enhancing the operation of the access regime and regulatory outcomes.