REVIEW OF TELSTRA PRICE CONTROL ARRANGEMENTS

Submission to the
Australian Competition
and Consumer Commission

February 2010

1 Summary

Vodafone Hutchison Australia Limited (**VHA**) welcomes the opportunity to comment on the Australian Competition and Consumer Commission's (the **Commission**) discussion paper entitled *Review of Telstra Price Control Arrangements* (the **Discussion Paper**).

VHA is Australia's third largest telecommunications company. Our products and services are marketed under both the Vodafone and '3' brands. We have a strong interest in retail telecommunications services and a demonstrated commitment to offer market-leading mobile voice and data services to the public.

In summary, VHA submits that:

> Retail price controls are undesirable as a matter of principle and should only be implemented as a last resort where the incumbent enjoys significant market power and effective market outcomes are not otherwise achievable. Price controls distort price signals that would otherwise encourage new entry; are invariably set above or below the efficient level; and entrench a lack of competitive discipline.

> Price controls are inferior to regulatory intervention which targets the source of market failure in the telecommunications industry, particularly access to bottleneck infrastructure on reasonable terms.

> VHA considers that there is insufficient competition in fixed telecommunications markets and Telstra continues to enjoy significant market power in those markets. This includes the market in which fixed to mobile (**FTM**) services are supplied. In this respect, VHA welcomes the following regulatory developments which may address the market failure in fixed telecommunication markets:

  > the proposed structural separation of Telstra;

  > the design of appropriate access arrangements for the NBN; and

  > the proposed amendments to the telecommunications access regime in Part XIC of the *Trade Practices Act* 1974 (Cth) which are likely to streamline access arrangements.

> VHA considers that the policy rationale for regulating FTM pricing using a price sub cap (or as part of a basket of services) is no longer compelling as a result of the Government's proposed structural reforms to the telecommunications industry and evidence regarding the extent to which subscribers are increasingly relying on mobile services rather than fixed line services.

> In circumstances where steps are being taken to increase competitive pressures from within the relevant markets, retail price controls should not also be used to impose artificial "competitive" outcomes on those markets.

> A continuation of the current price control arrangement for a further three years is appropriate as an interim measure while the NBN is rolled out, and the vertical separation of Telstra and other amendments to the telecommunications access regime are implemented. Following this transitional period, VHA considers that proposed reforms to the access regime should render price controls unnecessary.

> In the event that the Government's proposed reforms are not implemented, then price control arrangements for Telstra should continue until the NBN Co is fully operational.

> VHA considers that legitimate social policy objectives can be achieved through instruments other than price controls.

The remainder of this submission is structured as follows:

- Section 2 explains the limitations associated with retail price controls as a regulatory tool and therefore the reasons why it should only be used as a last resort.
- Section 3 discusses why the reform agenda of Government and recent industry developments are more appropriate tools for addressing market failure in fixed telecommunications markets.
- Section 4 discusses the welfare analysis of FTM price regulation undertaken by Analysys Mason.
- Section 5 discusses the use of price controls to achieve social policy objectives.

2 Retail price controls are undesirable

The Commission has described the objective of retail price controls as being to promote efficient pricing outcomes where competition is not yet fully developed.[1] VHA does not regard the use of price controls as the most effective means for achieving pro-competitive regulatory outcomes. There are a number of reasons for this. First, retail price controls seek to replicate outcomes in a competitive market but without addressing the reasons for the market failure. Second, it is inherently difficult to arrive at retail price controls which do not in fact hinder the development of sustainable competition in relevant markets.

The Productivity Commission, in its review of the *Prices Surveillance Act* 1983, identified the limitations associated with retail price controls and concluded that 'the generally preferred option for dealing with monopolistic pricing is to increase competitive pressures within the market'.[2] The Productivity Commission further noted that:

> *The problems with price control have been acknowledged generally by Governments in Australia. This is reflected in the trend to pro-competitive reform and the increasingly diminishing role that Governments have given price control over the last two decades. Given the limitations and potential costs of price control, it should be considered a remedy of last resort, applied only in important markets after careful evaluation of the options.*[3]

VHA considers that the following matters significantly limit the regulatory effectiveness of retail price controls:

1. Price controls distort price signals that would otherwise encourage new entry
   As the Commission recognises in it Discussion Paper, 'new entrants are attracted to a market by the prospect of financial return that is commensurate with the risks involved in their investment'.[4] New entry into fixed line services markets requires significant

[1] Discussion Paper, p 7.

[2] Productivity Commission Inquiry Report, *Review of the Prices Surveillance Act 1983*, 14 August 2001, p 33.

[3] Ibid.

[4] Discussion Paper, p 16.

investment, even if the entry is 'access/service-based' or 'quasi facilities based' rather than 'facilities based'. In the absence of price controls, supra-competitive prices charged by an incumbent attract new entrants to the market. Following successful entry competitive forces then have the opportunity to drive prices towards their efficient level without the need for regulation. In the extreme case, price controls can require the incumbent to price some services below cost, with the practical consequence that new entry in respect of these services is effectively impossible.

2. Price controls create incentives for inefficient entry
   The Discussion Paper also notes the possibility that price controls can create incentives for inefficient investment by new entrants in low cost areas where the incumbent is effectively prevented from competing on price by the requirement to offer uniform prices across high and low cost areas.[5]
3. Price controls entrench a lack of competitive discipline
   Price controls mask the price signals that would attract new entrants and entrench the current market structure. The dependence on regulation to force prices towards their competitive levels is self-perpetuating and real competition is unlikely to develop unless appropriate market incentives exist.
4. Price controls are invariably set above or below the efficient level
   In practice, price controls seldom reflect the economically efficient level due to:

> information asymmetries (regulators will never be in a position to know with precision the cost structure of an incumbent);
> the fact that price controls tend to be set in advance for a period of several years; and
> a conflict between the goals of achieving allocative efficiency and creating incentives to pursue cost efficiencies (which may involve allowing the incumbent to retain some of the benefit of cost efficiencies by reducing the regulated price by less than the amount of the cost saving).

3 Developments in fixed line telecommunications markets

3.1 Introduction

In the past, Vodafone and Hutchison supported the limited use of price controls in relation to FTM services for the following reasons:

> Telstra continued to exercise substantial market power in the supply of FTM services;
> competition in the supply of FTM services was unlikely to emerge as the previous regulatory environment did not facilitate effective new entry and sufficiently prevent Telstra from engaging in anti-competitive conduct; and
> given the lack of competition in fixed telecommunications markets, the reduction in the cost of the mobile terminating access service (MTAS) was unlikely to be passed on to end users.

[5] Discussion Paper, p 18.

The current review is, however, occurring while the regulatory landscape is evolving. The Government now recognises the limitations associated with the current regulatory regime in addressing market failures in fixed telecommunications markets. To that end, the Government has proposed a number of structural reforms to the telecommunications industry with a view to addressing those market failures. These reforms, and the manner in which they address market failures, are addressed below.

VHA submits that the existing retail price controls should not be expanded or otherwise amended to seek to address market failures. In circumstances where steps are being taken to increase competitive pressures from within the relevant markets, retail price controls should not also be used to impose competitive outcomes on those markets. That said, a continuation of the current price control arrangement for a further three years is an appropriate interim measure while the Government's reform agenda is implemented. Following this transitional period, VHA considers that proposed reforms to the access regime should render price controls unnecessary.

In the event that the Government's proposed reforms are not implemented, then price control arrangements for Telstra should continue until the NBN Co is fully operational. Under such circumstances, we would expect a further review of price control arrangements would be necessary in three to five years.

3.2 New regulatory environment

3.2.1 The vertical separation of Telstra

The *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill* 2009 (the ***Draft Bill***) contains a number of important measures designed to address the structural causes of market failure in retail fixed telecommunications markets, including Telstra's vertical integration. In VHA's view, effective vertical separation of Telstra (whether structural or functional) should go some way towards removing the need for retail price regulation.

As the Government makes clear in the Explanatory Memorandum to the Draft Bill, the objective of vertical separation is:

> *to address concerns created by Telstra's vertical integration by reducing Telstra's ability and incentive to discriminate against other service providers and to promote greater equivalence and transparency which will encourage greater competition across the telecommunications industry.*[6]

While Telstra's network infrastructure exhibits natural monopoly characteristics, retail fixed line services need not. Vertical separation has the potential to make retail markets genuinely contestable as:

- wholesale access on non-discriminatory terms will facilitate new entry; and
- greater market transparency will limit the opportunities for Telstra to engage in anti-competitive conduct at either the wholesale or retail level.

[6] Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill* 2009, p 24.

VHA's general support for the Draft Bill is set out in a submission to the Senate Standing Committee on Environment, Communications and the Arts for the purpose of its inquiry. More detailed comments on separation arrangements for Telstra and on streamlining the access regime are contained in the separate responses of Vodafone and Hutchison to the Department of Broadband, Communications and the Digital Economy's *National Broadband Network: Regulatory Reform for 21st Century Broadband* discussion paper.

3.2.2 Streamlining the Part XIC access regime

The Draft Bill proposes to replace the cumbersome negotiate-arbitrate model with a regime that requires ex-ante determinations of the terms of access by the Commission. VHA considers that the proposed amendments will significantly increase the effectiveness of the telecommunications access regime and thereby reduce impediments to retail competition for the provision of fixed line services and facilitate new entry.

3.2.3 The NBN

The NBN will operate on an open access, wholesale only model[7]. Effective access mechanisms should promote the development of robust competition in downstream markets with the result that efficient retail pricing may arise without the need for regulatory intervention. VHA submits that price controls during the early stages of the NBN could impede the development of competition and that the focus should, in the first instance, be on effective structural arrangements and access mechanisms.

3.3 Market developments – fixed to mobile substitution

The Commission's Discussion Paper refers to its previous assessment which found that 'whilst there are signs that some competitive influence is being exerted on fixed voice and broadband services by the mobile voice and data services provided by the mobile networks of Telstra, Optus and Vodafone/Hutchison, they are yet to reach the point of being full or effective substitutes'.[8] VHA notes that the assessment referred to by the Commission related to the 12 months to June 2008.

VHA views that the right market definition for voice and data services is a broad one. While VHA does not consider that mobile services are a fully-effective substitute for fixed line services in all circumstances, consumers are increasingly using mobile services rather than fixed line services for the purpose of voice calls including calls to mobile phone subscribers. [c-i-c]. The increasing substitution of mobile services for fixed line services, coupled with the range of structural and regulatory reforms that are underway or envisaged, means that the Government should allow competition to develop without imposing an artificial outcome on those markets.

[7] Joint media release issued by the Prime Minister, Treasurer, Minister for Finance and Minister for Broadband, Communications and the Digital Economy on 7 April 2009, accessed at http://www.minister.dbcde.gov.au/media/media_releases/2009/022;

[8] Discussion Paper, p 14, referring to ACCC, *Telecommunications competitive safeguards for 2007–2008 — changes in the prices paid for telecommunications services in Australia 2007–2008*, 2009, pp. 12-13, which in turn refers to research conducted by the Australian Communications and Media Authority (*ACMA*) and reported in ACMA, *Fixed-mobile convergence and fixed-mobile substitution in Australia*, July 2008.

4 Welfare effects of FTM price regulation

The Commission's Discussion Paper refers to a report by Analysys Mason[9] that reviews the approach taken by some overseas regulators to regulation of FTM pricing and the impacts on welfare from regulating FTM and MTAS prices. The Analysys Mason report concluded that regulating FTM pass through (such as through price cap regulation), together with MTAS access prices, would have a positive net impact on overall welfare (consisting of a significant increase in consumer surplus, a moderate increase in mobile network operator (MNO) surplus and a notable loss in fixed network operator (FNO) surplus).[10]

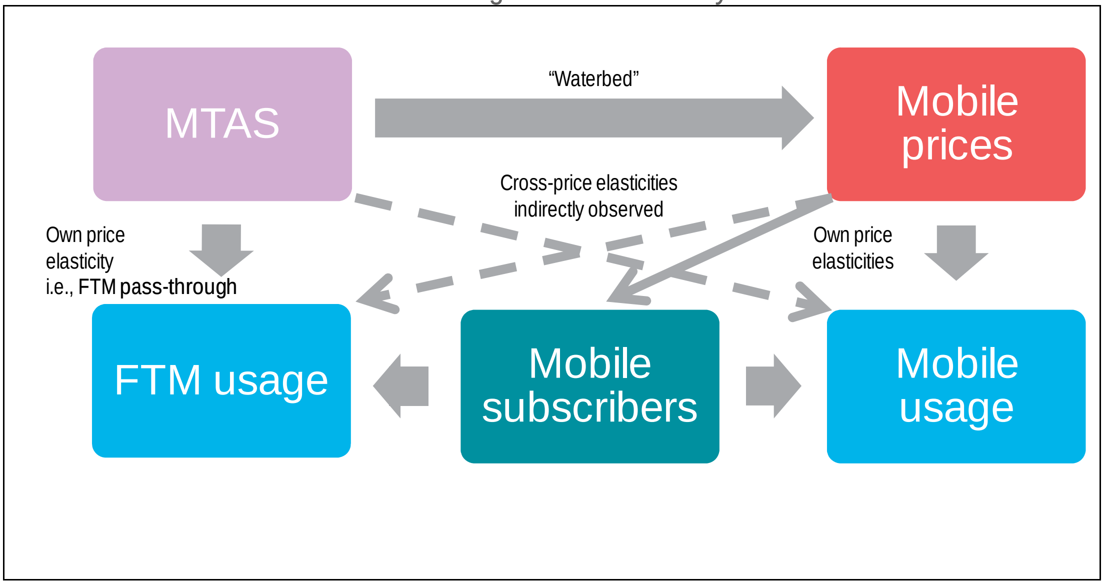
VHA does not consider that the results of the Analysys Mason modelling justify regulation of FTM pricing (nor is the study, by itself, sufficient to justify MTAS regulation):

- The Analysys Mason model does not take into account the potential for FTM price controls to impede the development of effective competition by distorting the price signals that would otherwise encourage new entry.
- The Analysys Mason model essentially quantifies the benefits of FTM services being priced at the efficient level, but does not address the issue of whether, as a matter of policy, the Government should rely on regulation of prices as opposed to the promotion of competition through other regulatory measures.
- VHA submits that modelling FTM services alone, without considering the interrelationship between MTAS, FTM services and mobile services, is likely to distort the analysis. For example, the 'waterbed' effect must be factored into any analysis regarding the welfare effects of MTAS regulation. As the Commission is aware, the waterbed effect refers to the observed phenomenon whereby a reduction in MTAS revenue leads to an increase in retail prices for mobile services (including MTM). Chart 1 below represents the interrelationships between the various relevant inputs to the welfare analysis of MTAS regulation. VHA submits that a more thorough welfare analysis is required before further regulatory intervention is justified on this basis.

[9] Discussion Paper, p 14-15; Analysys Mason, *Regulatory treatment of fixed-to-mobile pass through*, October 2009

[10] Analysys Mason, *Regulatory treatment of fixed-to-mobile pass through*, October 2009, p 46.

Chart 1: Linkages in the welfare analysis



Source: Sandbach, J. 2007, 'Welfare analysis' in *The Economics of Mobile Prices*, Vodafone Public Policy Series, Number 7, November.

5 Social policy objectives

The Discussion Paper notes that in addition to efficiency objectives, price control arrangements have also sought to achieve certain social policy objectives, such as ensuring consumers from different geographic areas and with different income levels have access to affordable telecommunications services.[11] VHA supports the pursuit of these objectives but notes that legitimate social policy objectives can be achieved through instruments other than price controls. For instance, VHA is not opposed to the continuation of:

- the low income measures in clause 22 of the Carrier License Conditions (Telstra Corporation Limited) Declaration 1997; and
- the pricing parity obligation in relation to the price of local calls and basic line rental services in non-metropolitan areas.

However, for reasons that are beyond the scope of the Commission's review, VHA submits that there is no longer any basis for the continuation of the universal service regime under Division 2 of Part 2 of the *Telecommunications (Consumer Protection and Service Standards) Act* 1999.

6 Conclusion

Retail price controls are a remedy of last resort and should only be used where other initiatives are not realistically capable of producing market outcomes. Price controls almost invariably fail to set prices at efficient levels in practice and can inhibit the development of competition by distorting the

[11] Discussion Paper, p 8.

price signals that would otherwise encourage new entry. While there may have been a need for this remedy of last resort in the past, VHA's view is that developments in the telecommunications industry and the various structural reforms proposed by Government have the potential to facilitate the evolution of effective competition in fixed line services in the short to medium term. VHA submits that, following a transitional period for which the current arrangements are maintained, these structural reforms should be given the opportunity to demonstrate their effectiveness and price controls should only be reintroduced if and when it becomes clear that effective competition will not develop.