TELSTRA CORPORATION LIMITED

Second Round Submission to the

Productivity Commission Inquiry into Telecommunications Specific Competition Regulation

24th October 2000

Executive Summary

Telstra welcomes this opportunity to put these supplementary views before the Productivity Commission Inquiry into Telecommunications Specific Competition Regulation. The purpose of this submission is to describe the reforms that Telstra believes are essential if Australian consumers are to enjoy the full benefits of a thriving and competitive telecommunications industry. In conjunction with this submission, Telstra will provide the Productivity Commission with a separate report on the state of competition in Australia.

In its initial submission to the Productivity Commission, Telstra highlighted the highly competitive nature of the Australian telecommunications industry. Yet, Telstra also identified the skewed patterns of investment that are evident in telecommunications infrastructure in Australia, particularly in relation to the local loop.

In Telstra's view, these trends – a direct a result of the regulatory regime – already do, and will continue to, undermine the benefits that competition has so far produced. It is of particular concern in this regard that the regulatory regime appears to be discouraging investment in competing local loop infrastructure, most notably outside the three major CBDs. The longer term implications are serious - particularly for rural consumers. The available evidence suggests that the regulatory regime may deny the bulk of non-CBD consumers the benefits that would flow from key industry dynamics: sustainable, efficient competition; the technological dynamism of convergence; and the full integration of the Australian economy into the information age.

In this submission, Telstra proposes that, in view of the state of competition, the high costs imposed by the current industry specific regime and the policy intent underpinning the Act, substantial legislative changes are required. Specifically, in Telstra's view, Part XIB of the *Trade Practices Act* 1974 (Cth) ("**the Act**") now needs to be repealed; and Part XIC of the Act should be harmonised with Part IIIA.

As Telstra demonstrates in this submission, the policy principles underpinning the market conduct regime in Part XIB of the Act are very clear - the Part XIB market conduct regime was only ever intended to be a transitional measure. Furthermore, it was introduced against the backdrop of more than seven years of infant industry assistance and was intended only to last until competition was sufficiently strong to warrant a return to general competition law regulation. Given the development of competition, the conditions required for that transition to occur are now clearly fulfilled.

Furthermore, this submission demonstrates that substantial efficiency costs arise from the Part XIB market conduct arrangements. These include the effect these provisions have in deterring Telstra from competing vigorously, and the slowing of the extent and timing of technical change.

Telstra therefore submits that there is no justification for ongoing industry-specific conduct regulation. The transitional conduct provisions contained in Part XIB of the Trade Practices Act should therefore be repealed in favour of the general safeguards contained in Part IV of the Act.

In terms of regulating access, Telstra believes that some industry specific regulation continues to be necessary in those parts of the customer access network ("**local loop**") that can genuinely be classed as bottleneck services. However, the process of convergence will increasingly reduce the need for regulation of the local loop, and strengthen the case for ongoing regulatory forbearance.

Telstra submits that Part IIIA of the Act should eventually replace Part XIC of the Act. However, Telstra acknowledges that important transitional issues need to be addressed before the telecommunications specific access regime can be folded into the general access provisions. Specifically, complex issues arise from the interaction between the policy goal of any-to-any connectivity and the retail price caps, requiring regulation of termination charges on all networks, at least for so long as controls over retail prices remain in place.

In the interim, Telstra proposes significant amendments to Part XIC. Telstra's proposed amendments regarding declarations include redrafting the declaration test, introducing sunset clauses and providing for full merits review. For undertakings and arbitrations, Telstra proposes removing the powers to implement interim determinations in arbitrations, and allowing for undertakings to be made before declaration to provide greater investment certainty. These reforms, which reflect a significant harmonisation of Part XIC with the Part IIIA general access provisions, are necessary to ensure that intervention is strictly limited to the residual areas of market failure.

Furthermore, Telstra contends that changes must be made to the pricing principles employed by the ACCC when determining the price of access to declared services. At present, the ACCC's pricing principles do not require that access prices be set in a way that ensures that access providers can recover efficiently incurred costs. Telstra therefore recommends a set of pricing principles to be enshrined in the Act, which would better provide for the recovery of efficiently incurred costs.

Telstra will soon provide the Productivity Commission with Appendices to this submission. In these Appendices, Telstra will respond to issues that arose in the first round of public hearings and the submissions of other interested parties, as well as some residual issues raised in the Productivity Commission's discussion paper that Telstra did not address in its first submission. Telstra provides detailed accounts and substantial material in relation to several of these topics; and, recommends specific legislative amendments in relation to a number of issues that currently are dealt (or not dealt with) under the *Telecommunications Act* 1991 (Cth).

1 Introduction and Overview

Telstra welcomes the opportunity to make this supplementary submission to the Productivity Commission Inquiry into Telecommunications Specific Competition Regulation.

This submission:

- Proposes a rationale for the ongoing development of the regulatory regime, and suggests the next steps that should be taken; and

- Responds to a number of issues raised at the August 2000 public hearings and in first round submissions to the Commission.

1.1 The State of Competition

In our initial submission, we described the state of competition in the Australian telecommunications industry. We highlighted how Telstra faces well-placed, robust, competitors in all those market segments where regulation has not inhibited the development of competition.

This view of the state of competition has been challenged in other submissions. Accordingly, Telstra has commissioned a separate assessment of this issue. This report will be made available to the Commission shortly.

Given the separate report, Telstra does not address the issue of competitive developments further in this submission. However, Telstra is of course happy to respond to any specific queries the Commission might have in this regard.

1.2 Regulatory Development

Given the progress of competition, Telstra believes that the current transitional regulatory regime needs to be modified in important respects. More specifically, the regime needs to evolve towards the original, long-established, public policy goal of reliance on the operation of the market, subject to standard competition laws and other legislation.

Where transitional industry-specific (or firm-specific) regulation is no longer warranted, it needs to be withdrawn expeditiously. Otherwise, the community will face the prospect of inefficient regulatory intervention interfering with desirable commercial outcomes. It is in recognition of this fact that the regime now in place was always conceived by Parliament as merely transitional. The substantial costs to which this regime gives rise makes a move towards less intrusive, but no less effective, arrangements all the more important.

In contrast, prolonging the current regime would impose costs on the community in the form of regulation that is both over-reaching and economically inefficient. It also risks fostering firms whose prospect of market success is dependent on regulatory largesse, rather than their own competitive abilities. The cultivation of such a regulatory clientele is inimical to both economic efficiency and to good public policy and administration[1]. Rather, where transitional measures support weaker market players, efficient structural adjustment requires those measures to be withdrawn as soon as practicable, to avoid them become a source of dependency rather than assistance.

This submission therefore sets out four main proposals:

1.2.1 Access declarations

Telstra proposes measures to move the transitional Part XIC access arrangements closer to the standard economy-wide measures in Part IIIA, resulting in:

- A redraft of the declaration test;
- The introduction of sunset clauses on all declarations;
- A reformed mechanism for revocation of declarations; and
- Provision for full merits review of declaration decisions

These measures are necessary to ensure that the regime is applied only to those residual areas where there is clear evidence of market failure and where intervention is demonstrably effective.

1.2.2 Undertakings and arbitrations

Here also we propose measures to move the transitional Part XIC access arrangements closer to the standard economy-wide measures in Part IIIA by:

- removing the powers to implement interim determinations for arbitrations – thereby requiring the ACCC to make only final determinations; and
- allowing for undertakings to be made before declaration, to provide "investment safe harbours".

1.2.3 Access Pricing

Telstra proposes a revised set of pricing principles for inclusion in an amended Part XIC. The objective is to afford the ACCC the external discipline, when assessing the reasonableness of access undertakings or in making arbitration determinations, to support it in promoting:

1 The Productivity Commission's own Office of Regulation Review guidelines require that, in designing efficient regulatory responses, policy makers need to carefully balance the costs of market failure against the potential for regulatory failure.

- Competitive neutrality among firms;
- Consistency with the broad principles of economic efficiency; and
- Recognition of the need for investors to earn a commercial return on investments that are prudently made.

Telstra notes the significant concerns expressed in many submissions to this Inquiry about the failure of the undertaking and arbitration processes to operate efficiently and effectively. Telstra shares these frustrations. Indeed, Telstra bears the greatest cost of the weaknesses in the current arrangements. Telstra believes that the reforms it has proposed of the declaration / undertaking / arbitration processes and the access pricing principles will go a long way to addressing these concerns. If the scope of the regime is more properly defined and access seekers no longer see the arbitration process as a one-way bet, the number and length of arbitrations is likely to diminish. Furthermore, if the ACCC is forced to adhere to economically efficient pricing principles in its assessment of access charging proposals, Telstra will be much more forthcoming in providing undertakings.

1.2.4 Alignment of Part XIB with Part IV of the Act

Telstra proposes the repeal of the Part XIB industry-specific conduct provisions, which it believes have consistently worked against economic efficiency. It is the general provisions of Part IV of the Act that should, in conjunction with the telecommunications access regime in Part XIC, be used to address any misuse of market power in the Australian telecommunications industry. Repeal should take effect as soon as possible, but in any case no later than 30 June 2002, the fifth anniversary of its introduction as a transitional measure and over a decade after competition was first allowed in the Australian telecommunications industry.

1.3 Other issues

Telstra's second major objective in this submission is to respond to issues that arose in the first round of public hearings and the submissions of other interested parties, as well as some residual issues raised in the Productivity Commission's discussion paper that Telstra did not address in its first submission. These issues will be addressed in the Appendices. Among the issues discussed in the are: a proposal for generic undertakings; an assessment of the factors that make ACIF successful; an examination of a proposal for multi-party arbitrations; an examination of the need for *ex ante* regulation; an assessment of the relationship between industry convergence and regulation; a review of the proposed reintroduction of dominance tests; a critique of proposals for the introduction of cease and desist powers; and a critique of proposals for compulsory lodgement and variation of undertakings.

2 Telecommunications policy, regulation and industry adjustment

Prior to consideration of the specific issues involved in the Commission's Inquiry, Telstra believes it is helpful to re-state the basic rationale and policy principles that underpin the current regulatory regime. These have been clearly set out by policy makers throughout the process of the regime's development.

Besides this overarching government policy intent, it is also relevant to consider the economic case for policy evolution – and specifically, the case for harmonisation of the current industry specific arrangements for telecommunications with the general competition provisions of the *Trade Practices Act* 1974 (Cth) ("**Act**").

Telstra notes that the Productivity Commission is required to have regard to the intent of Parliament in establishing the review of industry specific regulation, the state of competition in the telecommunications market, and the impact of new technologies. The policy principles at issue, and competitive and technological developments in the telecommunications market, should therefore be of particular importance in framing the Commission's analysis.

In this section, Telstra:

- Sets out some fundamental principles that have characterised the regulation of Australian telecommunications over the period since the initial moves to liberalisation;
- Illustrates these principles with respect first, to the regime that prevailed from 1991 to 1997 and second, to that in place since 1997; and
- Considers the implications for the Commission's current Inquiry.

2.1 A regime long in transition

Australian telecommunications policy has, for over a decade, been based on two fundamental principles: first, that regulation can and should be used to assist the industry's transition to competition; and second, that as competition becomes better established, regulation should become less intrusive.

Industry-specific (and firm-specific) legislation has been relied on to achieve the objective of promoting the transition to competition because of the widely held apprehension that, in the absence of special provisions, the industry structure inherited from the past could delay or preclude competition from emerging. As the industry has evolved from first monopoly to duopoly and then to open competition, measures akin to structural adjustment support for the emerging competitors have therefore been adopted – but in the interests of competition, not to support *competitors* per se. Indeed, at each stage in the process, it has been recognised that *as successive milestones are reached in the development of market forces, it is important to move to less intrusive approaches to regulation.* Two factors underpin this recognition.

The first is that competition, once established, is naturally a vigorous force that needs little protection, above and beyond that provided by the general instruments of competition policy. A regulatory regime that purports to protect competition as if it were highly vulnerable, risks inhibiting bona fide competitive conduct and suppressing the very vigour of competition that supports efficiency and innovation. As a result, once competition is well-established, the regulatory support measures need to be withdrawn as soon as possible, lest the industry, or some of its firms, become structurally reliant upon them.

Second, regulators, no matter how scrupulous they are in the pursuit of the regime's goals, will inevitably make mistakes in attempting to second-guess the outcomes that market forces would otherwise have generated. Avoiding the costs that these mistakes would otherwise impose on the community as a whole justifies a move to less intrusive regulatory arrangements as soon as market developments permit. As the Productivity Commission's Office of Regulation Review has noted:

> While some regulation is necessary and beneficial, there are some cases where it may not be so or where it could be better designed. Regulation should not only be effective, but should also be the most efficient means for achieving relevant policy objectives….
>
> Determining whether regulation meets the dual goals of 'effectiveness' and 'efficiency' requires a structured cost-benefit approach to policy development. The relevant problem to be addressed and subsequent policy objective should be identified as a first step in the policy development process, followed by consideration of a range of options (including no action) for achieving the objective. The benefits of any regulation to the community should outweigh the costs.2

As a result, each phase in the development of telecommunications policy – with those phases broadly paralleling the evolution of the competitive market – has reflected the objectives of a move from more intrusive to less intrusive regulatory arrangements, the ultimate goal being that of moving from an industry-specific regime to one that relies solely on the competition policy instruments that apply economy-wide.

2.2 From monopoly to duopoly – the first transition

Aside from some competitive entry possibilities in the late 1980s, the process of telecommunications liberalisation commenced in 1991 with the establishment of the transitional duopoly for competition in the supply of fixed links[3]. This five-year transition was supported by separate legislation, aimed at supporting and regulating the initial phase of competition, administered by a separate industry regulatory agency ("**AUSTEL**"). These measures were then considered necessary to undertake the task of removing those artificial barriers to competition that had evolved under the statutory monopoly regime. The scale of this task was obviously difficult to predict. Nonetheless, the clear intention was to proceed to an open market with maximum reliance on economy-wide regulatory measures as soon as Optus' exclusive franchise permitted.[4]

---

2 Office of Regulation Review, 1999, A Guide to Regulation, 2nd Edition, www.pc.gov.au, pp. A1.

3 Later, a third mobile carrier, Vodafone, was added to this transitional structure.

4 It is important to note that under both the Telecommunications Act 1991 (Cth) and its successor legislation, allowing economies of scale and scope to be achieved and fully exploited has been an explicit goal of policy. Regulation has been given the goal not of preventing those economies from being achieved, but merely of preventing them from being used against the interests of economic efficiency – that is, from being used in ways which prevent competition from developing *where the underlying economics would allow it to efficiently do so.*

Relative to this goal, it is generally accepted that the 5-year period for these transitional arrangements was too long[5]. The 1991 Act was highly interventionist in general and was particularly prescriptive in the restrictions it imposed on Telstra's conduct. These restrictions generally served to blunt competition between the duopolists, and allowed many prices to remain at high levels during the duopoly period. Moreover, the extensive transition period may have itself hindered the later development of additional competition by entrenching duopoly arrangements. It also encouraged the emergence of a class of resale competition that was based, in essence, on arbitrage between regulated wholesale prices and retail prices that were distorted by the duopoly and by other, social, regulatory requirements. This form of competition, in itself, did not meet the policy aim of "sustainability".

2.3 From duopoly to open market – a second transition

The 1997 legislation was the next step in this transition. It largely replicated, for the transition from duopoly to open market, the functions of the 1991 legislation. Consistent with the aim of moving towards the earliest maximum reliance on economy-wide regulatory instruments and institutions, those economic regulatory functions for the industry that affected competition and consumers were vested in the ACCC. The transitional industry-specific regulatory provisions were amended and transferred to the Trade Practices Act.

In the interim, there had been material change to the Act in response to the Report by the Independent Committee of Inquiry ("**Hilmer Report**"). In particular, the Act now included provisions for regulating access to essential facilities to facilitate competition in downstream markets[6].

The 1997 legislation significantly revised and codified the telecommunications industry-specific provisions. Nonetheless, they were still expressed to be transitional – a way-station along the road to the earliest possible and fullest reliance on the standard economy-wide provisions of the Act. This legislation was amended in 1999 to vary the industry-specific provisions dealing with market conduct. Arguably, these amendments increased the differences between these provisions and the standard economy-wide provisions.

In principle, the legislation provides for three main industry-specific measures:

- ***network interconnection* measures**. These give effect to the public policy interest in telecommunications networks being interconnected and interoperable in order to enable "any-to-any connectivity" – essentially to allow a customer of any network to connect seamlessly to a customer of any other network;

---

5 Telstra understands that its duration may have been largely dictated by the requirements of the then principals of Optus, the incoming duopolist, who sought an extended period of protection from further market entry as the counterpart to the obligation to acquire AUSSAT Pty Ltd that had been imposed as the price for entry to the market.

6 Telstra understands that the absence of economy-wide essential facilities access provisions in the TPA in 1992 was a material consideration in the decision to adopt separate industry-specific regulation at that time.

- ***access* measures**. These provide for continuity with the industry-specific pre-"Hilmer" arrangements adopted in 1991. They give effect to the public policy interest in the promotion of competition in downstream markets. They also seek to give effect to the public policy interest in such access being on terms that send efficient signals to the market about future investment in such facilities. These measures depart from the standard access provisions in Part IIIA of the TPA in three ways:

  – Declarations: to be made on the basis of the long term interests of end users ("**LTIE"**) test, not sunsetted and with no review appeal rights;

  – Undertakings: possible only after services have been declared, not before, excluding their use in creating investment "safe harbours" ; and

  – Access pricing: also set on the basis of the LTIE test.

- ***Competition/market conduct* measures**. These reflect the public policy interest in ensuring that market power in the telecommunications industry is not used to substantially lessen competition. The measures involved two main departures from those of standard competition law:

  – Effects Vs purpose: standard competition law proscribes the use of market power with anti-competitive *purpose.* The industry-specific provisions refer to *effect*. Some market conduct that involves the use of market power could, arguably, have an inhibiting effect on competition that would be incidental to its commercial purpose. Such conduct is allowable in the wider economy, but proscribed in the telecommunications sector. Presumably the Parliament decided that, to support the transition to an open market, it was appropriate to deprive Telstra temporarily of the full degree of commercial flexibility enjoyed by the rest of the economy. At some stage – and Telstra submits that time is now – consistency was to be restored[7];

  – The "competition notice" regime: This acts alongside the standard provisions in the TPA for access to injunctive relief and compensatory damages, giving the ACCC powers to act at a low evidentiary threshold and for the clock to be immediately started on stiff cumulative penalties (ie. prior to prosecution).

The transitional nature of these provisions is plain from the legislation. Thus, Parliament has stated in respect of Part XIB that:

> "It is intended that competition rules for telecommunications will eventually be aligned, to the fullest extent practicable, with general trade practices law. Part XIB will apply for the period

7 Any argument for the retention of an "effects" test in telecommunications must logically address the rationale for not extending this test to the rest of the economy. If the separate provision were to be retained, then – sooner or later – it would encounter complex boundary issues, as industries converge, and as the convergent industries become embedded into the "new economy".

> from 1 July 1997 until some future review determines that competition is sufficiently established that the Part or some provisions of the Part are no longer needed."[8]

The Parliamentary status of this rationale establishes it as a guiding principle for this review.

2.4 Competition has developed

The purpose of this transitional regime was always to foster the development of sustainable competition. Competition has now developed. Telstra's view is that it has developed alongside, and sometimes despite, the application of this regime.

The development of competition has received widespread recognition. For example, the Minister for Communications, Information Technology and the Arts made the following media statement on 11 September 2000:

> **"Telecommunications competition going from strength to strength"**
>
> Australian consumers will continue to benefit from the strong growth of the telecommunications market with the announcement by the Australian Communication Authority of the 50th telecommunications carrier licence, the Minister for Communications, Information Technology and the Arts, Senator Richard Alston said today.
>
> 'Competition in the carrier market is a key driver of growth and innovation in Australia's telecommunications industry,' Senator Richard Alston said.
>
> 'From a base of three in 1996, 50 carrier licences have now been issued since full competition was introduced in 1997, as investors continue to show confidence in the domestic market and demand continues to grow.
>
> 'The number of carriers and other services providers continues to climb - exposing the telecommunications market to more competition, resulting in far greater choice for consumers in telecommunications products, services and price.
>
> 'Australians have enjoyed steady price falls since July 1997 in the cost of international and long distance calls as a result of the Government's decision to allow new phone companies into the Australian market.
>
> According to figures released by the ACCC in April this year consumers have continued to benefit from significant price reductions across most services between 1995 and 1999. Local call prices are down by 15%, STD rates down by some 40%, and long-distance call rates are down by about 60%… [9]

2.5 Industry convergence and regulation

In Telstra's view, structural change in telecommunications will further intensify the competitive pressures that are already so clearly at work.

---

8 Trade Practices Amendment (Telecommunications) Bill 1996 – Explanatory Memorandum. Parliament of Commonwealth of Australia, House of Representatives 1996 (Circulated by authority of Senator Hon Richard Alston, Minister for Communications and the Arts).

9 ATUG Conference, Sydney, 11 September 2000.

In taking this view, Telstra recognises that some industry participants have argued that convergence between telecommunications and broadcasting markets[10] requires the continuation and even strengthening of industry specific regulation. However, careful analysis of the convergence process has led Telstra to the opposite view – that convergence is likely to both reduce the need for pre-emptive telecommunications regulation and increase its cost.

By the very process of convergence, the number of facilities-based providers of service will increase. This is because delivery medium for broadcasting and telecommunications are becoming increasingly indistinguishable. In particular, all the existing electronic and electromagnetic delivery systems – copper pair, HFC, LMDS and satellite, and the next generation of cellular networks – are now capable of supplying both broadcast services (one-way content delivery) and telecommunications services (two-way broadband). As such, any market power that may have existed in markets pre-convergence is being eroded.

Moreover, as market boundaries become blurred and more services become substitutes for others, firms can more quickly obtain minimum efficient scale in different markets by reaping new economies of scale and scope in the converged technologies. Thus, entry into areas which were once considered natural monopolies becomes much simpler. For example, CWO could justify investing billions of dollars in an HFC cable network because from the same investment it could seek to reap revenues from the provision of Internet access, voice telecommunications services and subscription television services.

In addition, the process of convergence greatly increases the scope for regulatory failure. To begin with, regulators often ignore the new competitive dynamic that convergence brings. Instead they continue to regulate incumbent firms as if they were no longer facing additional competitive constraints. For example, despite the presence of CWO's competing access network that sits on its Pay TV network, and ongoing investment in new broadband access technologies such as LMDS (in metropolitan areas), access continues to be heavily regulated. Moreover, convergence can often result in competing firms being subjected to separate regulatory regimes. This is especially likely to be the case where declarations are technology-specific -- as for example, in the case of the analogue Pay TV declaration.

In short, the historical rationale for both industry specific conduct and access regulation are further weakened by the process of convergence that is now underway.

2.6 Regulation at Telstra's expense is no longer valid

The development of competition has important implications not only for the regulation of the industry generally but also and specifically to the manner in which Telstra's interests are dealt with in the regulatory process.

---

10 For more detail on these technologies and their commercial supply see Little, Ralph and Wong "Regulation and convergence of the telecommunication and content industries", NECG Papers, November 1999, pp. 3 and beyond, which has an Australian perspective, and Speta, J. "Handicapping the Race for the Last Mile?: A Critique of Open Access Rules for Broadband Platforms," Yale Journal of Regulation Vol. 17 (1) Winter 2000.

Telstra believes that, at least in the period prior to 1997, policy and the administration of regulation proceeded, in part, on the implicit basis that:

- The advantages of Telstra's market incumbency were available to be "traded off" in the interests of potentially increased competition; and

- Telstra's shareholder value was not only immaterial in consideration of regulatory issues, but – at least at the margin – was seen as a reasonable sacrifice to make in the interests of promoting competition.

So long as Telstra was wholly owned by the Commonwealth, these were valid – even if arguably not wholly appropriate - policy positions for the Commonwealth to adopt. However, following the partial privatisations of Telstra in 1997 and 1999, it is now appropriate for the Commonwealth to ensure that policy settings do not result in appropriation of Telstra's bona fide market position, or its shareholder value.

No less importantly, these policy positions need to be compatible with competitive neutrality and hence with long term economic efficiency. If allowed to impose unique burdens on Telstra and effect what would be no more than income transfers from Telstra to its rivals, they would distort investment and output decisions, yielding outcomes that have nothing to do with competition on merit. The costs this imposed may have been slight in the past, but would not be so in the future.

Achieving a regulatory regime that protects competition in a manner consistent with competitive neutrality and with the core economic goals of efficiency is the central aim of the proposals this submission sets out.

3 Development of the Access Regime

3.1 Overview

Telstra believes that the time is right to move the current telecommunications access arrangements closer to the general access provisions set out in Part IIIA of the Act.

Two factors underpin this view. The first is that competition has now developed (or, absent regulatory distortions, is now capable of developing) so as to eliminate the need for the expansive regulation the current regime provides. Second, and no less important, there are widespread and costly deficiencies in the current arrangements, which are best dealt with by more effectively constraining the scope for regulatory failure.

This section concentrates on the nature and extent of the regulatory failure associated with the current arrangements. More specifically, it:

- Examines the economic costs associated with the provisions that deal with service declaration and with the pricing of declared services;

- Sets out a proposal to amend these mechanisms, so as to secure outcomes more consistent with economic efficiency; and

- Discusses the manner in which transitional issues, arising in the move away from the current arrangements, should be dealt with.

3.2 The economic costs of the current regime

As Telstra emphasised in its first submission to the Commission's Inquiry, the current regime sets a very low threshold for declaration. The ACCC has acted on this basis, and has extended the scope of declaration to services that on any objective test would be seen to be provided competitively.[11] The ACCC appears to have operated on the premise that declaration is a relatively low cost decision, so that erring in favour of declaring services would, in and of itself, not impose efficiency losses on the community.

This approach is, in Telstra's view, wrong. To begin with, the reality is that declaration alters industry dynamics, as it changes market participants' perceptions of the choices and instruments open to them. As a result, the outcomes that can be observed in the supply of declared services will always differ from those that market forces, left to their own devices, would have yielded. Declaration therefore forecloses the option of allowing market forces to develop unhindered, and only if it becomes apparent that they are failing bringing regulation into play. A regime that allows declaration to proceed **before** there is compelling evidence of market failure risks preventing markets from ever being allowed the time they need to do their work.

It is not easy to identify the magnitude of the costs this entails. This is not surprising, as what is at issue here is the loss of an option value: that is, the loss

---

11 As stated in Telstra's first submission, an example of this is the ACCC's declaration of analogue Pay TV services.

associated with extinguishing the option of permitting markets to self-correct. The mere fact that these losses are difficult to measure does not, however, make them any less real.

In practice, the regime also imposes other costs that are more readily evidenced. These include the direct costs of compliance and the wider economic costs of the distortions the regime creates.

3.2.1 Compliance costs

Most immediate are the compliance costs: that is, the costs involved in actually administering and fulfilling the requirements declaration brings. These costs are substantial, for at least four reasons.

First, declaration triggers the Standard Access Obligations ("**SAOs**"). These oblige potential access providers to take steps to make third party access possible, quite independently of whether there is any demand for the declared service. As third party access must be made possible on terms that are broadly technically equivalent to those which the access seeker provides to itself, systems and processes must be developed that will allow equivalence to be achieved. As a result, the access provider incurs fixed costs that may never be justified by the extent of demand for the access service.

Second, declaration reduces the incentives for matters to be resolved through commercial negotiation. In theory, declaration could leave these incentives unchanged, if it merely altered the parties' "threat points" (that is, the best they could achieve if negotiations did not succeed). However, in practice, declaration introduces new uncertainties, and will always cause the parties to question whether they could not do better going to arbitration. Once an arbitration process is underway, other parties are reluctant to reach commercial agreement, for fear that the terms on which they do so will be less favourable than those available to their rivals. As a result, issues that could have been dealt with commercially, often at relatively low cost, get escalated into the more highly formalised, lengthy and costly process of regulatory price determination.

Third, the costs associated with this extensive and expanding reliance on regulatory price determination are compounded by the ACCC's reluctance to allow effective use of the Undertaking mechanism. In principle, Undertakings were to be an important element in the regime, reducing the transactions costs the regime might otherwise involve and consistent with the Government's emphasis on promoting industry self-regulation. Hence, in introducing the 1997 legislation, the Minister observed that:

> "The Government will also be encouraging the larger access providers to submit an access undertaking for ACCC acceptance. This would both improve the certainty surrounding the terms and conditions on which those persons must comply with the access obligations and provide increased certainty for access seekers.[12]

12 Second Reading Speech, p.9.

In practice, however, the regime itself has features that discourage access providers from relying on Undertakings: most notably, the fact that the rights of review relative to ACCC decisions appear to be more limited in respect of Undertakings than they are with respect to the outcomes of ACCC arbitrations. Even more importantly, the ACCC has acted in a way that makes it particularly unattractive for access providers to offer Undertakings. In particular, the ACCC's process for reviewing Undertakings has proven to be extremely lengthy and involves continuing pressure for the release of substantial amounts of confidential information. This may be appropriate in the context of relatively slow moving and basically monopolistic industries such as electricity distribution, but it is not appropriate in an industry where the pace of developments is sustained and where the information being disclosed can be used to commercial, competitive ends. As a result, arbitration, despite its costs, will in many cases be preferable to attempts to secure approval of a voluntary Undertaking.

Fourth and last, the ACCC has acted, and has incentives to act, in ways that increase the costs of arbitrations. More specifically, the ACCC has not sought to complete arbitrations in a timely way – that is, to speedily issue final determinations; rather, it has preferred to rely on its powers to make interim determinations, which are free of any threat of appeal. Interim determinations have a maximum life of one year; but may potentially be renewed at the expiry of a 12 month period for another year, and so on. In practice, the ACCC has let interim determinations stand in the market for the maximum period the legislation allows. The ACCC's first interim determination in relation to PSTN originating and terminating access is a case in point: the ACCC allowed that interim determination to stand in the market for precisely 364 days. The ACCC's interim determination in relation to the digital data access service has, at the time of writing, stood for 10 months.

More generally, it is Telstra's observation that the ACCC's management of the arbitration mechanism has been characterised by delay and uncertainty, as evidenced by the ACCC's failure to make final decisions in a timely and effective manner. For example the ACCC:

- has not reached a final determination in relation to *any* GSM arbitration, even though some of those arbitrations were lodged almost two years ago; and

- has not made a final determination in respect of any local call resale arbitration, in spite of the first of those arbitrations being lodged with the ACCC more than one year ago, and there now being seven such arbitrations queued for ACCC decision.

In short, the ACCC's implementation of the current access regime has: increased the uncertainty that bears on market participants; by extending the duration of arbitrations, increased the costs the parties must incur; and eroded the rights of appeal Parliament had clearly provided for in respect of ACCC decisions.

3.2.2 Wider economic costs

Substantial as the direct resource costs arising from these features of the current arrangements are, they are dwarfed by the economic costs caused by the regime's processes and their outcomes.

In assessing the extent of these economic costs it is important to note that they are affected by the sheer number of services that have been declared. To begin with, the regime's very wide scope stretches the limited resources that can be used to support Part XIC's decision-making processes, and hence reduces the quality of the decisions taken. Even more importantly, the regime now covers many services that are relatively close substitutes in supply and/or demand: examples include DDAS and ISDN; the PSTN and ISDN; and PSTN, LCS and ULL. As a result, an error in the pricing of even one of these services spills-over to distort consumption and investment decisions more broadly.[13] The costs of inaccuracy are consequently greatly magnified.

These inaccuracies have, in Telstra's view, been great. In effect, the ACCC has used its broad discretion with respect to access pricing to determine charges that are inconsistent with the elementary requirements of economic efficiency.

Telstra starts from the premise that efficient investment, and sustainable delivery of the services consumers demand, cannot and will not proceed if investors are not allowed to recoup the costs that investment entails. This is no more nor no less than investors would be able to expect in a competitive market: that is, that the anticipated revenue stream from investments prudently made will be sufficient to maintain intact the capital invested. It is therefore a cornerstone principle of efficient regulation that the allowed revenue stream should permit capital maintenance for investments prudently undertaken. This translates into a requirement that the allowed revenue stream should at least suffice to provide zero economic income: that is, should be at least enough to keep capital intact.

There are broadly two concepts of capital maintenance. The first, which is of central importance in economic analysis, is the maintenance of *financial* capital: this requires a revenue stream actuarially consistent with the legitimate expectations of investors at the time the investment was undertaken. The second, which has been emphasised in replacement cost accounting, and notably in asset valuation approaches such as Optimised Replacement Costs, is the maintenance of *physical* capital: this requires a revenue stream actuarially sufficient to permit the operating capability or service potential of the capital stock to be kept intact. Both of these concepts are relevant in Telstra's case:

- Absent an expectation of financial capital maintenance, it will not be possible to finance socially efficient investments;

- When a firm has an obligation to provide service, as is the case with Telstra, the physical capital maintenance concept measures the disbursements it will need to effect over time so as to meet that obligation; the anticipated revenue stream

13 More specifically, within the bounds of substitutability, access demand will always migrate to the service with the lowest effective price; it suffices for any one of the substitutable services to be priced at less than cost for all of the transferable demand to become non-compensatory.

going forward must be sufficient to ensure that those disbursements can be made.[14]

As a result, the regulator, in determining allowed revenue, must ensure that income is sufficient to be consistent with financial capital maintenance **and** with the demands the firm will face in keeping its service potential intact.

In practice, in telecommunications, the ACCC has paid no direct attention whatsoever to financial capital maintenance. As a result, it has not inquired what the consequences of its decisions would be for the income stream that would accrue to the investors that financed the assets now being used to provide service.[15] Rather, the ACCC's focus in most instances[16] has been on developing cost models that, in the tradition of some strands of the physical capital maintenance approach, seek to determine the minimum outlays that a firm would need to engage were it currently to construct the facilities needed to provide the service.

In theory, this amount could provide some guidance as to the minimum amount a firm would accept to provide a service on a long term basis. However, it will only do so if properly implemented, notably in terms of the internal construction of the estimate, the method by which it is translated into an annual, per-unit charge and its consistency with the other key variables (especially the Weighted Average Cost of Capital ("**WACC**")) used in determining the stream of costs. The ACCC's approach has been seriously deficient in each of these respects.

The ACCC's consideration of Telstra's charges for originating and terminating PSTN access illustrates the range and magnitude of the errors involved. A few points can usefully be made here:

- In terms of internal consistency of the estimates, the ACCC has discounted Telstra's estimates of the number of lines required to provide service on the basis of the assertion (which Telstra believes to be incorrect) that some part of this number is actually capacity required to meet demand in future periods.

- The ACCC accepted that it was efficient to provision those lines in the current period; but felt that their costs should be booked to future periods. However, the ACCC, in then calculating the charges for these future periods, has ignored the substantial costs it had thus deferred to them. The result is that these costs are effectively treated as a capital loss that falls on Telstra's shareholders.

---

14 Note that this does not imply that revenue must be such that the firm can finance these investments from payments for current depreciation. All that is required is that the revenue stream be sufficient to allow these investments to be made, given the most efficient means of financing them.

15 It might be claimed that these assets are sunk, and hence that providing them with a return is unnecessary. However, this assumes, in a manner quite inconsistent with evidence and analysis, that investors do not view current behaviour as indicative of future behaviour: i.e. that the regulator can credibly commit not to expropriate sunk investments in future.

16 The Local Carriage Service ("LCS") for which the ACCC has adopted a "revenue minus avoidable costs" approach is an exception discussed separately.

- The ACCC has not attempted to justify this approach, which is clearly at odds with internal consistency in the calculation of costs and can only discourage efficient investment.

Moreover, there are sharp inconsistencies between the approach used to determine the capital base, the method used for calculating depreciation, and the method used to determine the WACC. This disregard for costs, and for the legitimate expectation that prudent investments will be recovered, is even more evident in the ACCC's approach to the pricing of the declared local call resale service (the "Local Carriage Service" or **LCS**). The key fact is that Telstra is required to supply local calls at a retail price that falls well below the long term cost of supply.

When Telstra supplies local calls to itself, it recoups the resulting shortfall through the enhanced likelihood that it will obtain from the customer purchasing those calls, additional revenues in the form of other types of calls (notably, fixed-to-mobile, STD and IDD).[17] Indeed, it was the existence of that linkage – between the supplying of local calls, and the likelihood of attracting custom for preselected calls – that provided the main justification for the ACCC's decision to declare the local carriage service. It follows that when the local call service is provided to the retail customer by a carrier other than Telstra, Telstra's prospects of receiving the preselected revenues for other types of traffic are diminished and hence its ability to recoup its costs is negated.

In Telstra's view, this means that there are two options for pricing the supply of local call resale to competitors.[18] In the first, the LCS charge would simply reflect the costs Telstra incurs in the long term supply of the service. This has the advantage of placing competitors in exactly the same position as is Telstra itself (that is, of having to recoup the gap between the cost of local call supply and the regulated retail price), and hence is competitively neutral, as well as providing the correct signals for long term build / buy decisions.

In a second option, the charge would be calculated by applying the Efficient Component Pricing Rule ("**ECPR**") to the service; this would be based on imputing to the service the full revenue Telstra obtains when it supplies the service to itself (including the incremental revenue associated with the greater likelihood of then securing sales of preselected services). This approach has the advantage that it would leave Telstra indifferent as between supplying the service to itself and supplying it to third parties.

In fact, the ACCC has adopted neither of these options. Rather, it has adopted a "revenue minus avoidable cost" methodology that, in calculating the revenues, takes just that from local calls and ignores the indirect revenues associated with the changed likelihood of supplying preselected services. This is despite the fact that it

17 The ACCC has not provided for the shortfall on local calls to be included in the Access Deficit Contribution paid for use of the Originating and Terminating PSTN access service. As a result, Telstra cannot recover this shortfall from the other types of traffic it carries on behalf of competitors.

18 A third option would be to include the shortfall made in the supply of local calls in the Access Deficit Contribution paid for use of the Originating and Terminating PSTN access service.

was those indirect revenues that provided the original basis for the service being declared. Given that the starting revenue falls below costs, the charge finally determined is inevitably insufficient to prevent Telstra from incurring a loss.

Overall, the ACCC's decisions with respect to the pricing of the local call resale service impose on Telstra's an obligation to subsidise its competitors - by an amount estimated to be over $2 million per month. Yet the ACCC has never articulated a coherent analytical basis for the approach it has adopted from the United States, where the institutional context is plainly different[19] and where that approach is now being questioned by the Courts.[20]

Telstra could, and will if necessary eventually address these shortcomings in the ACCC's approach through appeal to the Australian Competition Tribunal. However, the reality is that the ACCC, by relying on its powers to issue Interim Determinations, can postpone if not escape vulnerability to appeal. Further, while it relies on these Interim Determinations, it alters market processes in ways that are difficult, if not impossible, to reverse.

The ACCC's current process of review of Telstra's charges for the Unbundled Local Loop service ("**ULL**") also highlights the difficulties involved. Here the ACCC has issued a discussion paper which claims to find that the charges with which Telstra has gone to market are substantially too high. However, the underlying analysis on which this claim is based is highly questionable in two regards:

- The ACCC indicated in its pricing principles paper that it had used a modified version of the NERA model to assess costs relevant to ULL. The ACCC has subsequently indicated that while it intends to make these changes to the NERA model, these modifications to the model have not yet been done. It has instead used a simpler shortcut method.

- The simpler method has serious errors that bias the costs estimated downward.

Telstra believes extensive harm has already been done, including distorted market expectations and the associated severely diminished scope to negotiate agreements on a commercial basis.

3.3 The economic consequences

The decisions set out above are clearly likely to cause efficiency losses. However, it is in the nature of telecommunications as an industry that this harm is not readily quantified.

Most of the assets used in supplying telecommunications services are long lived; also, many are specific to their current use, in the sense that they cannot readily be

---

19 Most importantly, the deficit incurred by US suppliers in the provision of local calls at regulated charges is recognised as part of the deficit that needs to be funded through interconnection charges. As a result, even though the charge for these calls stands below long term costs, compensation is provided by other means.

20 See, e.g.,*Iowa Utilities Board, et al. v Federal Communications Commission and United States of America* No. 96-3321 (8th Circuit, 18 July 2000).

redeployed to other purposes. Moreover, at any point in time, the vast bulk of the network assets required to provide service are in place. As a result, policy changes that drive down the returns on these assets, even to levels that are obviously non-compensatory, do not provoke a discernible supply response, at least for some years. Rather, existing assets continue to be worked, even though the allowed returns are such that, had they been known in advance, investments in these assets would not have been made.

However, it is apparent that artificially depressing the return on investment reduces the incentives network providers have to maintain assets in the face of wear and tear. This is a significant consideration in Australia, where substantial parts of the Customer Access Network are in urgent need of refurbishment and/or complete renewal. Ideally, the regulatory arrangements would respond to this need by ensuring that investing in these activities was commercially attractive, and then relying on market forces to determine the precise pattern of the investments made. In practice, however, the response has been to make even heavier use of regulation so as to offset the distortions that regulation itself initially caused. More specifically, Telstra has been placed under pressure to carry out the investments needed to maintain the serviceability of the Customer Access Network by the imposition of minimum service standards, with substantial penalties being threatened in the event that these standards are not met. This generates an ever-increasing tension between the imperative to invest due to the need to comply with service standards, and the disincentive to invest that results from under-recovery of costs under the access regime.

In Telstra's view, the artificially low charges being set by the ACCC for access to Telstra's facilities are also reducing the incentives for investment in competing facilities by Telstra's rivals, even when these competing facilities would have lower costs to society than Telstra itself incurs. This outcome is, Telstra believes, to some extent an inevitable consequence of the use of an "efficient cost" standard, such as TSLRIC: this standard sets the access charge not on the basis of the costs Telstra actually incurs in supplying service, but on the lowest costs that might be incurred; it therefore removes the incentive any access seeker whose costs in supplying the access service really are lower than Telstra's might have to provide the service to itself.

In this sense, all "efficient cost" standards distort build/buy decisions. However, the extent of this impact is magnified by the manner in which the ACCC has interpreted the standard, and the very low level of charges in which this interpretation results. Telstra believes that this is a significant factor in the observed pattern of competitive investment – most notably, in the lack of investment in access networks by Telstra's competitors outside the CBDs.

Underpinning this assessment is Telstra's belief that the access network is not a natural monopoly. Absent inappropriate regulation, Telstra's competitors would have incentives to bring alternative access networks into service: Optus, for example, could make far greater use of its HFC network to provide telephony service, while companies such as AAPT would deploy fixed wireless networks far more aggressively than they are currently doing.[21] By allowing greater competition between networks using rival technologies, this would yield economic benefits that Telstra stressed in its first submission to the Commission's current Inquiry.

However, the issue of whether the access network is or is not a natural monopoly does not need to, and indeed cannot, be determined at this point. In effect, this is an issue that ultimately can only be settled by market forces. But market forces will not be able to play this role if the price signals facing industry participants are distorted – if it is made artificially attractive for firms to rely on Telstra's network rather than develop efficient facilities of their own. This makes it all the more important that the price distortions set out above are addressed and redressed.

Overall, it is Telstra's firm view that the price distortions arising from the current access arrangements will have substantial long-term consequences. If these arrangements are not reformed, Telstra itself will be increasingly reluctant – and unable - to undertake the investments needed to provide Australia with the high-quality telecommunications infrastructure the Australian economy requires. Nor will Telstra's competitors have any incentive to make up the resulting shortfall. Regional Australia, where costs are high and revenues uncertain, will be especially hard hit.

Averting these consequences requires significant adjustments to the current access regulatory framework.

3.4 Telstra's proposals

Telstra believes that the core failures of the current arrangement arise from the discretionary powers granted the regulator to (1) extend the regime's scope beyond that which can be justified by demonstrable market failure, and (2) determine charges for services brought within the regime's scope in ways which have little to do economic efficiency. As a result, Telstra is of the view that the regime needs to be reformed so as to better define its scope, ensuring that regulation is only applied to areas of clear market failure and where intervention can lead to better outcomes. Additionally, firmer guidance needs to be provided to the ACCC on the manner in which it can determine charges for services that do fall within the regulated arrangements.[22] Telstra's proposals in these respects are set out below.

Telstra submits that the current access arrangements – declaration, undertakings and arbitration - should be harmonised with those of Part IIIA of the Act.

The declaration of any new service would have to be effected consistently with the criteria Part IIIA sets out. However, as a transitional measure, all services currently declared under Part XIC would be deemed to remain declared. These declarations could be revoked, but a special test would apply. That special test would require that

---

21 It is worth noting that Optus has on numerous occasions stressed that its HFC network is now fully telephony capable. Indeed, in evidence senior Optus executives gave to the ACCC in the context of the proposed merger between Foxtel and Australis, Optus claimed that it both could, and intended to, provide local telephony service to 50% of homes by 1999. The only reason Optus could have for not doing so, given its repeated claim that local service is highly profitable, is that the regulated prices for LCS make the "buy" option so much more attractive than that of developing another source of supply.

22 In this respect, Telstra notes that Australia Post has expressed concern about the operation of proposed Part XID of the Act.

a service declaration would only be revoked if doing so would not impose costs to society that exceeded the benefits associated with its continued declaration. Those costs and benefits are to be determined with reference to: the extent of competition, including potential competition, in the supply of the service; the desirability of achieving and maintaining any-to-any connectivity on an efficient basis; the promotion of efficiency in investment in and use of the telecommunications infrastructure; the impact of any regulatory constraints on the ability of market forces to operate efficiently with respect to the service; and the public interest in ensuring that regulation is not extended to areas where it is not required.

With regard to declaration, Telstra believes that the arrangements set out under Part IIIA are superior to those provided for by Part XIC in three important respects:

- First, unlike Part XIC, Part IIIA allows for a separation of functions and powers as between the declaration and adjudication phases. Under Part IIIA, declaration is a power vested in the NCC, while the adjudication of disputes rests with the ACCC. In Telstra's view, this avoids the perceived conflict of interest that arises when the entity that will have powers to shape an activity also has the power to determine whether it should or should not be placed in a position where it can do so. The fact that declarations under Part IIIA rest on an objective test, and are subject to full review by the Australian Competition Tribunal, further limits the risk of "regulatory creep".

- Second, the declaration criteria under Part IIIA are far tighter than those provided for under Part XIC. Importantly, they are conditions, each of which must be met, rather than factors that must be taken into account but can be traded off. Moreover, they more sharply focus attention on the question of whether supply is or is not competitive, and hence ensure that regulation is not put in place where market forces could otherwise operate.

- Third, declarations under Part IIIA must be for a defined duration. This reduces the risk that services remain within the regime well after the factors that justified their initial declaration have disappeared. The additional arrangements Telstra proposes with respect to revocation would also contribute to minimising this risk.

Furthermore, the machinery for lodging undertakings under Part IIIA is superior to that under Part XIC. Under Part XIC, a carrier can lodge an undertaking in respect of a service *only* after that service has been declared – that is, regulated access has been mandated - by the ACCC. In contrast, under Part IIIA, an undertaking, once lodged (and if accepted), removes any potential for declaration of the service. Part IIIA therefore greatly reduces the scope for regulatory intrusion – or at least does not encourage intrusion - in respect of the commercial supply of that service. It also provides for "investment safe harbours" whereby the terms under which a service will be provided are known in advance of investment.

Finally, should arbitrations arise, Part IIIA does not allow for interim determinations to be made. As a result, some of the uncertainty and avoidance of accountability that has marked the ACCC's use of these determinations under Part XIC would be avoided.

Important as these advantages are, Telstra recognises that there are transitional issues that arise in telecommunications but might not be capable of being dealt with under the current Part IIIA arrangements. These issues derive largely from the requirement for any-to-any connectivity, which in turn translates into an obligation on carriers to interconnect. This obligation, when combined with regulatory constraints on retail prices, can allow carriers with even very small market shares to act in ways that can significantly distort market outcomes.

Thus, rigorous economic analysis has established that as a result of the operation of the Australian regulatory regime even very small networks are able to levy termination fees significantly above cost without reducing revenue per customer.[23] This is possible because the following regulatory factors prevent the incumbent network from retaliating:

- the statutory obligation to inter-connect – Telstra is obliged to terminate calls on other networks – means that Telstra cannot refuse to originate calls destined for other carriers' networks, no matter how high their termination fees;

- regulated access prices means that the incumbent cannot recoup higher termination fees through higher origination fees;

- in relation to the PSTN, the retail price controls on Telstra – notably the absolute constraint on local call charges – mean that Telstra has little or no scope to pass on to end-users high termination charges for local calls imposed on it by other suppliers of PSTN service. As a result, these other suppliers face a demand by Telstra for local termination services that is virtually completely inelastic.[24]

In short, due to existing regulation – some of which is necessary – so-called "non-dominant" networks have both the incentive and the means to set local termination charges at levels that are inefficiently high. This distorts investment decisions and results in allocative, productive and dynamic inefficiencies.

In the absence of broader regulatory reform, these distortions need to be addressed through regulation. More specifically, it needs to be recognised that so long as constraints remain in place that prevent Telstra from either disconnecting networks that set above-cost termination charges, or reflecting those charges in its prices to end-users, then these so-called "non-dominant" networks have an element of bottleneck power that can be used to seriously distort market outcomes. In the transition path suggested by Telstra from Part XIC to Part IIIA, these services would consequently continue to be regulated under the existing PSTN originating and terminating access service declaration, as this declaration would be brought, by the deeming provision, within the scope of the new arrangements.

---

23 See J. Wright, 2000, 'Non-dominant network competition'.

24 Based on Telstra's experience, the traffic terminating on non-dominant networks is predominantly local ISP-bound traffic and therefore the local call price-cap distorts demand for the bulk of the total traffic originating on Telstra's network and terminating on non-dominant networks. However, even for STD and IDD traffic terminated on other's networks, Telstra is limited by the retail price cap constraints in increasing prices to recoup high termination charges.

3.4.1 Pricing of declared services

In addition to clearer constraints over the scope of the regime, Telstra believes it is important to have measures in place that can ensure that access prices are set with greater regard to economic efficiency. More specifically, Telstra submits that the ACCC should be required to set access prices at levels that are sufficient to cover economic costs.

4 Development of the market conduct arrangements

Among the jurisdictions that have well-developed competition laws, Australia is virtually unique in having a special set of competition rules regulating market conduct in telecommunications.[25] Other countries, including those with fully vertically integrated carriers, have successfully made the transition to competition in telecommunications relying solely on the general competition laws to regulate market conduct. In Telstra's view, Australia's industry-specific competition rules are not only unnecessary, they are harmful to Australian consumers. They should therefore be abolished.

This section explains the background to the current arrangements for regulating market conduct for telecommunications, and sets out the reasons for their repeal.

4.1 The background

The market conduct arrangements set out in Part XIB are the legacy of a compromise that was struck at the end of the duopoly period. The 1991 Act, that defined the framework for the duopoly, imposed a number of relatively prescriptive controls on conduct by carriers generally, and by dominant carriers in particular. These controls, and most notably those related to price discrimination, had little basis in economic efficiency and in fact are likely to have allowed higher prices to prevail than would otherwise have been the case.[26]

However, as with most forms of regulation, the conduct arrangements had beneficiaries, in this case mainly in the form of Telstra's actual and potential competitors. As a result, there was strong opposition to simple repeal. Part XIB, which was less prescriptive than the 1991 Act's conduct controls, was the outcome this opposition managed to obtain.

The revised conduct controls were not meant to be permanent. Rather, it was apparent from the start that Part XIB was merely a transitional element in the move towards reliance on the competition laws that prevail economy-wide. The Explanatory Memorandum accompanying the legislation makes this plain when it says that:

> "Part XIB will apply for the period from 1 July 1997 until some future review determines that competition is sufficiently established that the Part or some provisions of the Part are no longer needed."[27]

---

25 While both the UK and Hong Kong have had rules of this type, they reflected perceived weaknesses in the more general competition laws. Thus, at the time of enactment of the telecommunications-specific rules in Hong Kong, Hong Kong did not have a general competition law. Equally, in the UK, these rules were enacted while the UK legislative framework for the competition laws was in the process of being harmonised with the provisions of the Treaty of Rome.

26 See Industry Commission, 1997, 'International Telecommunications Reform in Australia' Staff Information Paper, www.pc.gov.au, p. 42.

27 Trade Practices Amendment (Telecommunications) Bill 1996, Explanatory Memorandum. Parliament of the Commonwealth of Australia, House of Representatives 1996 (Circulated by authority of Senator the Hon. Richard Alston, Minister for Communications and the Arts).

Accordingly, the issue for this Inquiry is not **whether** a move away from these provisions is desirable, but rather **when** such a move should be made.

In considering this issue, Telstra starts from the premise that industry-specific forms of regulation should be avoided whenever possible. The presumption should lie in favour of relying on the laws and regulations that control conduct economy-wide, as this minimises the risk of inconsistencies developing between the treatment of differing activities, reduces the likelihood of capture and of other forms of regulatory failure, allows for greater certainty, and permits savings in the costs of compliance and administration.

The burden should therefore be placed squarely on those who support industry-specific arrangements to demonstrate that these are indeed needed to meet legitimate policy goals. This case has not , in Telstra's view, been made. Rather, both experience and analysis suggests that retaining Part XIB would impose costs that greatly exceeded any benefits it might provide.

This is first and most obviously because competitive conditions have now evolved to the point where the provisions are, at best, no longer required. Telstra's competitors are not fragile fledglings, incapable of withstanding exposure to the full vigour of competition. There is therefore no policy rationale for special protection.

Second, the access arrangements, especially if Telstra's proposals are adopted, make anti-competitive conduct implausible.

It is a matter of simple economics that a profit-maximising firm will not have incentives to outlay resources in excluding rivals if it cannot subsequently recoup the costs it has incurred by setting consumer prices at levels that allow it to earn monopoly rents. Indeed, the prices it can ultimately set must be sufficiently high to recompense it both for the time value of the moneys it has outlaid and for the risk those outlays entail (including the risk of penalties for anti-competitive conduct). This requires that the markets in which the firm operates, and in which recoupment will subsequently occur, are protected by substantial barriers to entry.

In practice, the access arrangements, taken together with the continuing requirements for preselection, number portability and the provision of billing information, will continue to ensure that any such recoupment is extremely unlikely. They therefore make the type of conduct at which the Part XIB provisions seem aimed no more plausible in this sector than they are in other areas of the economy- indeed, less plausible given the pervasive access regulation that characterises the telecommunications industry.

Third, to the extent to which any such conduct occurs, the existing disciplines of Part IV of the Trade Practices Act are capable of providing effective remedies.

Section 46 is a strong and well-established provision that has proved effective in regulating anti-competitive conduct in many industries in Australia. It differs from the Part XIB test for anti-competitive conduct in that it focuses on the purpose of the conduct rather than on the conduct's effect. While an investigation of purpose can be a more limited exercise than an examination of effect, the practical difference between these is slight. Moreover, if there are arguments that favour an effects test then the appropriate path is to consider amending section 46 to apply an effects test to the assessment of anti-competitive conduct in all industries.

Sections 45 and 47 are broader than section 46 in that they both refer explicitly to the effect of particular conduct as well as to its purpose. Section 45 prohibits provisions of contracts, arrangements or understandings that have either the purpose *or effect* of substantially lessening competition. Similarly, section 47 prohibits exclusive dealing that has either the purpose *or effect* of substantially lessening competition.

In addition, in relation to remedies, Part VI of the Act provides procedures under which injunctions may be sought to restrain conduct that is suspected of contravening Part IV, and also provides maximum penalties for a contravention of Part IV of $10 million for a corporation and $250,000 for individuals.

The ACCC has been effective in enforcing the competitive conduct provisions under Part IV of the Act and has a high success rate in the proceedings it has brought alleging anti-competitive conduct under these provisions. No less importantly, awareness in the Australian business community of the prohibitions on anti-competitive conduct in Part IV is high, and there is a well-developed understanding of the nature of the conduct that will be held to be in breach. Finally, Telstra's rivals have every incentive, and the means, to monitor for, and seek action against, breaches of these provisions.

As a result, Part XIB is unnecessary. But the case for repeal is stronger than this. In effect, the provisions set out in Part XIB impose substantial economic costs. Though these costs may seem to fall on Telstra, ultimately it is consumers that pay the price. Understanding these costs is therefore important for the current Inquiry.

4.2 The costs of Part XIB

Three features distinguish Part XIB. These are: that it is highly uncertain in its meaning; that the evidentiary hurdle that must be passed before its provisions can be triggered is very low; and that it exposes the party alleged to be in breach of the provisions to substantial penalties.

The uncertain nature of the Part XIB provisions is readily demonstrated:

- the effects test is untested in the Courts and its true application is more uncertain than that of the long-established purpose test;

- the effects test, following the 1999 amendments, now includes situations where a firm takes advantage of market power *"and engages in other conduct on one or more occasions with the combined effect, or likely combined effect, of substantially lessening competition"*. No guidance is available as to what this means; and

- Part A competition notices can now be issued specifying a broad range of conduct that the ACCC considers would contravene the competition rule, rather than particular, tangible conduct. This means that it may not be at all apparent to the party at which the notice is aimed, what the conduct is that has allegedly breached the rule.

At the same time, it is the very essence of the Part XIB provisions that the standard of evidence required before they can be brought into play is low. In effect, Part A and Part B competition notices can now be issued if the ACCC has only a *"reason to believe"* that there has been anti-competitive conduct. But the penalties associated with the system are nonetheless extremely high: a competition notice exposes the recipient not only to substantial adverse publicity, but also to pecuniary penalties of up to $10 million **plus** $1 million per day from the time the competition notice is served (subject to successful prosecution in court by the ACCC).

In Telstra's view, provisions such as these would be difficult to defend in any context. Even putting aside issues of natural justice, resting liability on standards as poorly defined as those set down in Part XIB is likely to impose high social costs. Ultimately, these provisions deter economically desirable conduct and act as a magnet for poorly founded complaints, as all the costs of demonstrating the propriety of its conduct are borne by Telstra.

In no instance have the claims made by the ACCC been substantiated in the courts. In Telstra's view, this largely reflects the very weak basis on which these claims rest. In the Internet peering case, for example, the ACCC failed to show that any of the preconditions required for a breach of the Competition Rule was met. Even more strikingly, in the STD $3 complaint, the Commission devoted many months to investigating, and forced Telstra to bear substantial costs defending a claim of a predatory price squeeze. Yet it was apparent, and indeed not contested by the parties, that it was not Telstra that had taken the lead in reducing prices to that level and that the complainant itself was setting charges below the level it claimed was predatory. Other complaints – such as those related to switchports – were, in Telstra's view, plainly misconceived: that they were made and not promptly dismissed merely confirms the distorted incentives the system creates.

Second and perhaps even more important, an analysis of the use made to date of Part XIB highlights the way Telstra's rivals and the ACCC have relied on these provisions to extract concessions that, if they had any substantive merit, would have been sought under the access regime.

The ISDN SPC case illustrates this point. That investigation arose from uncertainty as to whether Telstra would continue to provide Semi-Permanent Circuits ("**SPCs**") as an element of its ISDN service, once that service migrated from its previous mode of provision (which was by means of a dedicated, overlay, network) to being supplied through Telstra's digital local exchanges. Telstra was the only carrier internationally that offered SPCs; the reason it did so was to increase capacity utilisation on the dedicated facilities previously used for ISDN. As these dedicated facilities were being replaced by capacity shared with the PSTN, continued provision of SPCs would be economically inefficient.[28] Moreover, the costs of that inefficiency were likely to be high, as the rapid growth of Internet-related traffic strained the supply / demand balance at local exchanges.

---

28 SPCs are effectively permanent circuits. They therefore tie up capacity even when they are not being used. The PSTN and the ISDN are both circuit-switched services, which means that they are designed to allocate resources on demand. Tying up capacity in the way SPCs do is therefore highly inefficient whenever peak demand is relatively close to the capacity available.

There were numerous users of SPCs, but Telstra had, over a period of time, made it clear that the future of the service was not assured. Alternatives to SPCs, that were more efficient in their use of network resources, were readily available. Moreover, those alternatives were within, or in the process of being brought within, the access arrangements set out in Part XIC. Hence, any pricing issues could be determined within the framework those arrangements provide.

Despite this, the ACCC used the threat of Part XIB proceedings, with its attendant damage to Telstra's reputation and risk of severe penalties, as a way of cementing the entitlements of the then users of SPCs. In effect, the ACCC sought, and Telstra reluctantly provided, for the advantages those users obtained to be preserved – regardless of the cost to the efficient provision of the service.

A similarly clear use of the provisions to entrench existing entitlements, in the face of technological changes which made those entitlements costly and counter-productive, marks the DC continuity complaint. At issue here was the use of lines that Telstra had provided essentially for telemetry purposes to supply DSL. These lines could not be so used if the network was modernised.[29] Moreover, their use for DSL created serious risks of interference, and could thereby undermine the effective carrying capacity of the network.

In practice, these efficiency concerns were given no weight by the ACCC. Rather, the ACCC's concern, in a manner plainly inconsistent with the "long term interest of end-users" test,[30] was with ensuring that inherited entitlements were preserved – with the cost to the community of so doing not being assessed, much less taken into account. The ACCC therefore sought, and Telstra reluctantly conceded, the *de facto* "grandfathering" of those entitlements, with Telstra being required to effectively buy out the beneficiaries of the new entitlements created. This creation of new entitlements, which then need to be preserved or bought out, also marks the Internet Peering case, the Tritel investigation, and investigation of CDNO.

In the Internet Peering case, for example, the Commission effectively required Telstra to enter into peering arrangements which it would otherwise not have accepted. From an economic point of view, these arrangements allowed the beneficiaries of the Commission's intervention to treat Telstra's backbone network as a common property resource.[31]

As a general matter, common property is an inefficient form of organisation. Because the marginal private costs of access to each access-seeker do not reflect the social costs access imposes, the resource will be over-used in the short-term. Additionally, long-term investment will be too low, as investors cannot anticipate capturing the

---

29 The lines could be used to provide DSL because they supported a continuous DC output from the customer's premise to the exchange. Telstra's network. Modernisation of the Customer Access Network generally involves providing a point of multiplexing between the customer and the exchange. At that point, an electrical to optical conversion occurs, which means that DC continuity is no longer available.

30 That test requires that account is taken of encouraging efficient use of the network.

31A resource is a "common property" resource if use of that resource is rivalrous (ie use by one party displaces use by another) but not subject to exclusion. The classic example of a common property resource are the ocean fisheries.

resulting returns. Further, because rights in common property are poorly defined, there is no guarantee that the resources will be used by those who value them most highly. Finally, any form of common property is likely to divert some resources from productive uses to socially wasteful investments in defensive and/or predatory activities. As a result, placing a resource into common property may (and usually will) lead to substantial rent dissipation.

These concerns are of clear relevance to Internet interconnection. In a peering arrangement between parties with over-lapping networks, each party has an incentive to shift traffic from its own network to that of its peer. As this happens, the party which shifts the least traffic suffers congestion, as its links are now carrying its peer's traffic as well as its own.[32] If this process continues, each of the networks will progressively shrink its output and investment, with there being no assurance that it is the most efficient network that will survive.

These efficiency implications appear to have been completely ignored by the ACCC. Not surprisingly, the remedy it obtained has distorted resource allocation in a number of respects:

- It has imposed additional resource costs on Telstra.[33] This is because the Commission has effectively required Telstra to accept arrangements in which it provides both peering and transit to Internet Access Providers ("**IAPs**"). As a result, Telstra has had to deploy equipment for traffic accounting which is both costly in itself and has an impact on network performance.

- It has conferred substantial benefits on the immediate beneficiaries of the requirement to peer.

- It has altered market behaviour in important ways. There are, in particular, strong signs that competing IAPs have restricted their investment in transport outside of the main Eastern metropolitan areas, relying instead on the Telstra backbone. As a result, the Commission's actions have tended to lessen, rather than enhance, diversity and competition in the provision of Internet backbone services.

In short, Part XIB has been used not to prevent conduct that is anti-competitive but as a means of conferring on Telstra's competitors *de facto* property rights in the Telstra network.

In Telstra's view, shared use ought to be regulated by the access regime; and such shared use ought to be limited to facilities that can be legitimately be regarded as bottlenecks. Obtaining and regulating such shared use by means of the Part XIB provisions is plainly inconsistent with the stated purpose of having an access regime: which is to provide an efficient and effective means of determining when

32Although Transmission Control Protocol ("TCP") provides a means of controlling congestion, IP networks are relatively vulnerable to quality degradation as a result of excess loads. This is partly because only 20 per cent of the traffic on the Internet is directly rate-adaptive, the rest using non-adaptive protocols such as UDP. It is also because TCP itself can be unstable when loss occurs simultaneously across a broad range of uses. This creates a condition known as global synchronisation in which vast numbers of parties attempt simultaneous retransmission. As a result, unplanned traffic shifts can impose major costs.

33That is costs above and beyond financial transfers.

and how access should occur. It is Telstra's view that the reliance that has been put on achieving access through Part XIB reflects the fact that the access being sought could not have been legitimately claimed under even the very loose tests that Part XIC now sets out.

This was strikingly evident in the Commercial Churn proceedings. The ACCC could have declared a churn service, and on that basis regulated the prices and other terms and conditions on which it was provided. But it could not so readily and surely do so in a manner which imposed all of the resulting burdens on Telstra, most notably the burden of providing a service at prices below cost. Reliance on Part XIB seemed to allow an outcome that was sharply discriminatory, as well as being economically inefficient.

These outcomes are, in Telstra's view, the result of the manner in which the ACCC has chosen to implement Part XIB. But it is the provisions as they now stand that both allow that use to occur and create strong incentives and pressures for it.

To summarise so far, it is clear that Part XIB has two major impacts: it deters Telstra from competing vigorously; and it allows transfers of rights and income to be made from Telstra to less efficient competitors.

The costs this imposes in terms of static efficiency are apparent. But there are also substantial costs in dynamic efficiency terms, most notably on the extent and timing of technological change. Thus, a major result of the ACCC's Part XIB intervention in respect of Unbundled Local Loop, where the technical issues third party access entails have been complex and slow to resolve (as they have in every other jurisdiction), has been to prevent Telstra from more speedily rolling out ADSL. Consumers in New Zealand, like their counterparts in the United States, have consequently been able to obtain ADSL service some two years ahead of consumers in Australia.

4.3 The future of Part XIB

It is a persistent feature of the Australian regulatory landscape that regulators are not willing to forego powers they have obtained, and faced with evidence of those powers' inefficient effects, seek to have the powers enhanced rather than removed. The history of Part XIB is consistent with that pattern.

In this context, it is not surprising that the ACCC has sought even greater powers under the telecommunications-specific provisions of Parts XIB and XIC. Thus, in 1999, the ACCC sought and obtained a further weakening in the processes it had to respect to issue a competition notice, and now is seeking a new power to direct Telstra to take particular action. In support of this, the ACCC has apparently claimed that omissions to act that are anti-competitive in their effect would not be caught by the economy-wide provisions of the Act.

This is clearly inaccurate. When there is a refusal, or even a decision not to do something, these actions will be caught by section 46 (and Part XIB) by reference to section 4(2) of the Act. Under section 4(2) "conduct" includes the doing or refusing to do any act, and "refusing to do an act" includes refraining from doing that act or making it known that that act will not be done. However, conduct (or "taking advantage") does require an active decision by the corporation - for example, section

4(2) excludes refraining "inadvertently" from amounting to a refusal and, therefore, from conduct. Where a corporation omits to do something merely because it has not considered it, there is no active decision and hence there can be no conduct under section 4.

It is to this situation alone that the ACCC's contention can refer. It follows that what the ACCC seeks are powers to intervene in circumstances where no decision of any kind has been taken – for example, where a firm is simply unaware of the fact that an access request has been made. However, it is apparent that this behaviour is in no way anti-competitive: it neither reflects nor requires market power; and the only remedy it calls for is that of informing the firm of the request at issue.

Overall, what the ACCC seeks would expand the scope of discretionary intervention well beyond what is needed to protect consumers and competitors. It is Telstra's view that if the ACCC believes it genuinely requires these powers, it ought to be compelled to seek them not on an industry-specific basis but rather economy-wide. Telstra submits that the reason the ACCC would not do so is obvious: while in telecommunications it can count on the active support of Telstra's competitors, any attempt to secure such powers economy-wide would face enormous resistance.

This highlights a well-known and important feature of industry-specific regulation: that by quarantining regulatory powers and actions to a narrow section of the economy, it weakens the monitoring and countervailing pressure that would otherwise discipline the exercise of regulatory discretion. In this specific instance:

- the costs of the industry-specific conduct regime fall in the first instance on Telstra, and are not readily visible to consumers;

- at the same time, firms in the rest of the economy need not view the ACCC's decisions as defining a precedent, and hence as posing a threat to their interests – so that they face few incentives to monitor these decisions and seek to intervene;

- while the benefits of the ACCC's decisions go to a small group of Telstra's competitors, who are well-placed both to use the system and defend it.

This structure of incentives results in the instruments of regulation being used not to increase wealth, but rather to redistribute it towards particular parties. Telstra submits that the Part XIB powers both lend themselves to this end, and have been extensively used to achieve it.

It is therefore time for these powers to be repealed. Competition in telecommunications, which is in any event strong, will only be enhanced by removing the distortions Part XIB has caused. At the same time, the repeal of these provisions will require the ACCC, when it seeks to control the terms on which Telstra's competitors can use Telstra's facilities, to rely on the more transparent and accountable processes of the access regime. Where anti-competitive conduct does occur, the ACCC as well as any parties adversely affected will have the full ability to rely on the Part IV of the Act.

These objectives should be secured at the first opportunity. In this regard, Telstra submits that the Commission should recommend the repeal of Part XIB no later than 1 July 2002.