VODAFONE SUBMISSION TO THE PRODUCTIVITY COMMISSION

Telecommunications Competition Regulation

Draft Report

10 May 2001

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Executive Summary

- It is timely to review the industry specific legislation for telecommunications. Since the introduction of competition in 1989, the industry has experienced dramatic change. New entrants and new technology have increased competitive pressure and end-users have benefited through lower prices and better quality as well as new products and services.

- The benefits of competition have been most strongly felt in the mobile market. Five network owners and a multitude of service providers have created one of the most competitive mobile markets in the world.

- The regulatory regime has had differing impacts across the industry. There has been little direct impact on the mobile market. However, we note recent moves by the ACCC to broaden its regulatory focus to include non-dominant PSTN operators and mobile networks. The rationale for this is very questionable. Regulatory interventions, especially one of access, need to be tightly focused on durable market failure. Investment and innovation are threatened by a broader scope.

- If properly implemented, the Productivity Commission's reform package should lead to an improved regulatory environment that would be more closely aligned with the general provisions of the *Trade Practices Act 1974*.

- However, we are concerned with some of the report's conclusions. In particular, we challenge the perceived pervasiveness of 'network effects'. These are overstated and should not be used to justify the continuance of an industry specific approach. Many examples used to highlight the impact of 'network effects' appear to have more to do with firm behaviour than industry structure. There is also a range of countervailing factors that largely remove opportunities for firms to take advantage of real or perceived 'network effects'.

- In addition, we consider that the new declaration criteria, when combined with the Productivity Commission's proposed changes to Part IIIA of the *Trade Practices Act 1974*, will not achieve the desired outcomes.

- This new competitive environment calls for a new regulatory approach. The history of regulatory intervention highlights the real costs of too much regulation. It is now time to stop treating telecommunications as a special case. The regime should be tightly focused on durable market failure with a formal bias in favour of market delivered outcomes rather than regulatory action.

1. Is a specific regulatory regime still appropriate?

1.1 Vodafone considers that a specific set of regulatory tools is no longer required to address competition issues in the telecommunications industry. We consider that that the Government should adopt a forbearance approach and act to remove regulations that are inconsistent with the general competition laws that apply to other industries.

1.2 We support the broad thrust of the draft report's recommendations, which would move the regulation of the industry towards a more generic approach. However, it is clear that the Productivity Commission (PC) considers that the industry still retains particular characteristics that require the maintenance of a specific regulatory regime.

1.3 Three arguments are used by the PC to rationalise specific regulatory intervention in the industry:

- Sunk costs of local network construction (the risks of a natural monopoly);
- Network effects (the risks of a lack of any-to-any connectivity); and
- The legacy of a historical statutory monopoly (the risks of undue dominance of the former incumbent network).

1.4 In addition, the PC argues that the barriers to entry posed by these factors are accentuated by additional factors:

- Consumer switching costs (large incumbent networks can increase consumer switching costs, which make it difficult for new entrants to compete); and
- The anti-competitive incentives that face a vertically integrated carrier (such as an incentive on the incumbent to resist providing access to its essential facility to new entrants).[1]

1.5 Our view is that, while these characteristics certainly exist in telecommunications markets, their influence on market development has been overstated and where it has existed it has declined or, in some cases, become irrelevant. As such, 'network effects' should not be used to justify a different regulatory approach in telecommunications to that applied in other industries.

[1] See page 2.6 of the Draft Report.

Network effects

1.6 The PC states:

> …if there were multiple unconnected telephone networks, each with identical costs and quality, a new customer would generally prefer the one with the largest number of customers…..The large provider could set high final prices for consumers by either restricting access to its network or setting terms and conditions for access that eliminate the capacity for competitors to reduce retail prices.[2]

1.7 However, it is difficult to contemplate in the Australian environment how a large provider could restrict access. A provider can only restrict access if it restricts access completely. With the continuing globalisation of communications it is impossible for a network operator to survive if it did not allow any external access to its network. As soon as one access seeker is provided access, whether national or international, transit opportunities are immediately created.

1.8 It is also difficult to see how a large provider could set terms and conditions that eliminate the capacity for competitors to compete in downstream markets. This could only happen where the large provider is a natural monopoly. If no natural monopoly exists then new network operators will have commercial incentives to duplicate the underlying facilities if the large provider attempts to charge monopoly prices. They in turn will be able to interconnect to the larger provider, either directly or indirectly.

1.9 If the larger provider sets access prices at a high level, the smaller provider will also set higher access prices. If the calling patterns of customers on both networks are similar, then interconnection charges are essentially a zero sum game. If both operators set low on-net call tariffs and high off-net call tariffs then the smaller provider immediately gets a relative revenue advantage since a greater percentage of their traffic will be off-net. This in turn will allow the smaller operator to lower off-net tariffs, eliminating any advantage the larger provider had due to the fact that a greater percentage of its customers' calls were on-net.

1.10 This example greatly simplifies the real market environment. In the real world, there are generally more than two operators, offering a multiplicity of services, some of them substitutes. Operators will behave rationally, and in the long run, set economically efficient prices which optimise traffic flows, and generate a reasonable return on investment. Given this, theoretical 'network effects' has little material impact on the functioning of the market. Regulatory intervention in

[2] See 2.12 of the Draft Report

order to address 'network effects' represents a significant over-reaction to address a problem that does not exist.

1.11 Empirical evidence tends to support this. Mobile operators have commercially agreed access charges that have not seen foreclosure of smaller networks. In some cases this has involved declared services, in other cases it has not (access to CDMA networks). We note that the current regime does not compel operators to seek access from other operators, it merely requires provision of access. Nevertheless access has always been sought and provided.

1.12 The same is true of GSM SMS services. If network effects were working according to theory, we would expect the larger provider - or providers - to foreclose on the smaller operators. This has not happened. Today Telstra has SMS connectivity between its CDMA and GSM networks. It is vigorously pursuing connectivity to other mobile networks. Telstra has strong incentives to pursue connectivity with all networks as it realises that there is much more to gain by establishing any-to-any connectivity as efficiently and quickly as possible.

1.13 Similar commercial incentives appear to be working in other network industries. For instance, Automatic Teller Machines (ATMs) are another network but one that does not require 'any-to-any' connectivity. Customers do not need access to every ATM in the world, just a reasonably large number. There is some advantage to the banks with the most ATMs but in practice commercial negotiations between banks over interconnection ensure that all customers are served.

1.14 Many of the examples used to highlight the impact of 'network effects' appear to have more to do with anti-competitive behaviour than industry structure. For example, 'network effects' are sometimes blamed for the ability of a dominant network owner to price discriminate between the prices it offers competitors for a wholesale product and the price it offers for the same product internally. However, this issue is more properly conceived as behavioural in nature – it has less to do with industry structure and more to do with market power and how it can be used.

1.15 In the mobile market sunk costs and issues connected to the influence of legacy elements of the Telstra network are largely irrelevant for assessing whether a specific regulatory regime is required for the mobile industry. The existence of a number of network operators provides clear evidence that sunk costs play no greater role in market development than they do in other industries that require large capital investments. In addition, competition and the fundamentally different "roots" of the mobile industry have meant that no legacy issues have ever existed. This leaves 'network effects' as the main argument for requiring a

different regulatory approach for the mobile industry. We consider that the influence of network effects has been largely overstated.

1.16 The influence of network effects is a relatively new area of economics.– However, it has become a significant economic argument used by regulators to apply regulatory oversight in mobile markets worldwide. Below, Velijanovski outlines the argument used by regulators and provides a view on whether it is appropriate for competition regulation:

> The communications sector harbours pervasive and ubiquitous **network effects**. These arise when the value of a network to its users increases with the aggregate number of users connected to it. **These demand side economics of scale** generate **positive feedback effects** ("success breeds success") as more join a network, ultimately **tipping** the market (**snowballing**) so that one network dominates. Consumers become **locked in** to the network. As a result even networks offering superior services cannot dislodge the larger network. Indeed, there is a **path dependence** which can see early **developers (first mover advantages**) becoming dominant by capturing new growth (**bandwagon effect**) so that the economy may adopt an inefficient solution. In short, the structural features of the new economy impel it to monopoly and inefficiency. This, in turn, justifies antitrust enforcement and sectoral regulation.[3]
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> As a recent survey concluded: "With so little empirical support for these (network) theories, it appears at best premature and at worst simply wrong to use them as a basis for antitrust decision.[4]

1.17 The Draft Report appears to suggest that similar arguments can be used to justify the regulation of mobile markets through a specific regulatory regime. For instance the PC appears to accept the ACCC's arguments about the impact of network effects for GSM termination services. In particular the PC characterises the mobile termination issue as one involving 'multiple bottlenecks'.[5] Multiple bottlenecks imply multiple monopolies (ie. each network owner has the ability to charge monopoly rates to fixed operators for calls terminating on their network). However, as discussed in our submissions to the ACCC on this issue, this analysis relies on an erroneous view of the relevant functional market and ignores the myriad of countervailing forces that mitigate any theoretical market power that network operators may possess with respect to termination rates.

1.18 The arguments in favour of specific regulation need to be assessed against current market developments. In the early days of deregulation, there may have been good reasons to adopt a specific set of regulatory rules for

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[3] Veljanovski, C., (2001), *EC Antitrust & the New Economy: Is the EC Commission's View of the Network Economy right?*, European Competition Law Review, forthcoming, p. 1 (emphasis in original)

[4] Ibid, p. 6. (quoting from S. Liebowitz and S.E. Margolis (1998), "Network effects and externalities" *The New Palgrave Dictionary of Economics and Law*, Vol. 2, Macmillan, p. 674.)

[5] See page 10.34 of the Draft Report.

telecommunications. However, we consider that the entire industry and the mobile market in particular have now entered a new competitive phase. Industry specific regulatory oversight is no longer required. The greater the difference between the regulatory regimes in telecommunications and those that apply to other industries, the greater the risk that investment distortions will occur, leading to sub-optimal outcomes for both industry and end-users.

1.19 Our view on the most appropriate regulatory regime has been shaped by our experience in the market place, both here and in other countries. Vodafone operates around the world as a 'mobile only' player. The mobile industry has developed in quite a different way to the fixed line network. Firstly, and perhaps most importantly, in most markets around the world end-users have had a choice between competing service providers from day one.

1.20 The mobile market has experienced unprecedented growth in recent years. More than half the population of Australia now own a mobile phone. As highlighted in our earlier submissions to the PC, the development of the market has been characterised by a number of important factors including robust price competition, significant product innovation, large investment. In addition, since 1997, two new network owners have entered the market (taking the number to five) combined with a large influx of other types of entrants brought about through sophisticated wholesale arrangements with network owners.

1.21 The mobile market is also creating competitive pressure across other segments of the telecommunications market. There is now a wide range of choices available for the consumer wishing to communicate - and an increasing range of technologies through which to communicate. For a significant number of customers, it now makes economic sense to substitute the mobile phone for their fixed line. For instance OFTEL recently completed a survey of households without a fixed line phone.[6] The report indicated a majority of these households used a mobile instead of getting a fixed line service. In addition in several countries such as Finland, there are now more mobile phones than fixed lines.

1.22 In other areas of the market, there are a number of investments being made that are providing customers with additional communication choices (eg. wireless local loops, fibre optic networks, satellite services and the use of existing electricity networks).

1.23 We consider that these trends in technology convergence are now removing the competition obstacles that have traditionally faced telecommunication markets.

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[6] See http://www.oftel.gov.uk/publications/research/unph0400.htm#summary

1.24 This has profound implications for the current regulatory regime. Dynamic changes are occurring in the market and Governments need to rethink the way that telecommunication markets are regulated. For the mobile market, we consider that the implications are clear. Forbearance should be the guiding principle for regulators, given the mobile market's dynamic and competitive nature.

1.25 The best way to introduce a forbearance approach in practice is to remove industry specific regulations and instead rely on the generic access and anti-competitive provisions of the Trade Practices Act (TPA).

1.26 There are a number of risks in keeping an industry specific regulatory regime. These relate mainly to the distorting impact of regulation on efficient market development. We consider that competition, rather than regulatory intervention, has been the main catalyst for the mobile market's development and accordingly can continue to be relied upon.

1.27 If it is judged that some parts of the industry, such as the local loop in certain geographical areas, still have elements of natural monopoly, we consider that this can be able to be dealt with by the general provisions of Part IIIA of the TPA.

2. Telecommunications Access : Rationale and Scope

A new objects test

2.1 We support a shift in the focus of the test towards overall efficiency and investment. Efficient use and investment in telecommunications should be the chief focus of the declaration test. We note that the recent Ministerial Inquiry into Telecommunications carried out in New Zealand last year recommended a similar objects test for their new regime.

2.2 This objective should be subject to a critical overarching criteria - a net public benefit test. Given the significant problems associated with regulatory error, there must be **strong** grounds for believing intervention will improve the overall welfare in the long term, taking into account the imperfections and risks of the regulatory regime (as outlined in section 2.5 of the Draft Report).

2.3 We consider that the current test skews decisions in favour of direct and measurable benefits to consumers – when there is a broader requirement to consider investment aspects explicitly. We believe that the adoption of the new objects test would focus the access regime on the key issues.

2.4 The focus on efficient investment is particularly important. Many of the key debates about access to telecommunications infrastructure have hinged on the impacts of regulatory intervention on the incentives to invest. Investment plays a critical role in the development of the telecommunications market. Greater consumer demand combined with the continuing need to innovate in order to compete effectively means that operators are constantly under pressure to invest and upgrade networks.

2.5 If the new objects clause is introduced, we would support any appropriate consequential amendments to Telecommunications Act.

A new declaration criteria

2.6 We agree with the PC that the existing criteria are imprecise and provide excessive discretion to the ACCC. Vodafone considers that:

- there should be consistency across Part IIIA and Part XIC; and
- the criteria in Part XIC are positively and inappropriately weighted in favour of declaration.

2.7 The suggested criteria improve on the existing ones. This is because the new criteria require that each factor must be positive established. This is in contrast to the current regime where it is arguable that any statutory burden of proof exists, as the ACCC is only required to have regard to certain matters.

2.8 Apart from one significant qualification (discussed below), the PC's approach works to align Part IIIA with the Part XIC declaration criteria. We support such an alignment. Telecommunications should not be treated any differently to other industry areas of the economy. However, our view on the new declaration criteria is impacted by the two tier recommendations to amend Part IIIA in the PC's Access Position Paper. We provide comment on the implications of this below.

The shift of focus from 'facilities' to 'services' for Part IIIA

2.9 Our major concern relates to the shift in the new criteria to a services centric approach and away from the facilities centric approach in the current Part IIIA. We are concerned that this change may unintentionally and unnecessarily entrench regulation of mobile terminating services.

2.10 A potentially radical departure in the PC's recommendations for the existing Part IIIA regime, is the shift from Part IIIA's current focus, in what we will call the

"bottleneck criteria", on the duplication of facilities to the provision of services by a second party. The focus on "service"[7] is likely to significantly impact on the declaration analysis by expanding the range of services that could be declared. For example, under the existing Part IIIA criteria, the service must be provided by means of a facility which is uneconomic to duplicate. However, the PC's tier 2 recommendation for the bottleneck criteria shifts the "duplication" focus to the service, and not the facility by which it is provided. Hence, the question is whether a second person could provide the service. Depending on how a service is defined, this potentially widens the reach of regulatory oversight to capture services supplied in contestable markets.

2.11 The issue then becomes what is the service. Taking an example from the mobile market, if the service is defined as generally originating and terminating access, then no problem should arise. If the service is defined as generally terminating access, then it is also clear that there are various providers of such a service. However, if the service is defined more narrowing as the service of terminating access to customers who subscribe to the operators' network, then it may be uneconomic for a second person to provide that service.

2.12 Further, the PC has proposed a significant qualification to the adoption of their tier 2 recommendations for Part IIIA. This involves the inclusion of a separate bottleneck criterion for originating and terminating services.

The practical impact of the new declaration criteria for Part XIC

2.13 While potentially providing more certainty and reducing the risk of arbitrary decisions by the ACCC, the new criteria are unlikely to lead to a significant departure from the current operation of Part XIC. In particular, the services declared under the new criteria may not be significantly different from the services already declared. In fact, it is at least theoretically possible that a greater range of services could be declared.

2.14 We have already noted the potential significance of a change to a services focus from a facilities focus in the bottleneck criteria. The other practical impact relates to the adoption of a two tiered approach to assessing the bottleneck characteristics of a service. In our view, this entrenches the view that there is a special form of market power in origination and termination that requires special rules.

[7] See page 142 of the Productivity Commission's Position Paper on Part IIIA.

2.15 In addition, it refers only to the existence of "substantial entry barriers" without requiring (as the criterion relating to other services does) that these barriers are effectively insurmountable. While new entrants may be subject to perceived network effects and a degree of sunk costs, these "barriers" can in most cases either be overcome or are irrelevant from a competition point of view.

2.16 The practical implication of this approach is that it will entrench the predisposition to declaration of origination and termination. Further, as noted below, while the other criteria notably (b) and (c) may work against declaration of originating access, there must be real concern that they would be sufficient to exclude continued declaration of terminating access.

2.17 The arguments against this view are largely economic, and were also covered in some detail in previous Vodafone submissions, and we do not discuss them here in any detail. However, we note that the argument for moving away from a duplication focus for originating and terminating access is not well developed and not sufficient to justify a radical departure from the general approach to access.

2.18 As a practical matter, the PC's test is unlikely to meet its objective of being easier to apply since the factors that have been proposed have not been subject to a sufficient level of judicial and professional debate.

Some suggested improvements to the PC's proposed criteria

2.19 We suggest that, as a minimum, the criteria be restated to only apply where "network effects or sunk costs prevent new entrants from effectively providing the service".

2.20 We note that criteria (b) and (c) are intended to provide substantial protection from the overly inclusive approach implied by (a). In principle, criterion (c) is a substantial improvement as it appears to be intended to focus not on the level of "market power" for the service itself, but on the level of market power exercisable in a downstream market. This is consistent with the current approach in Part IIIA, which requires that access promote competition in an upstream or downstream market. We agree with the PC's concern that the "promote competition" threshold is too low and its recommendation to re-craft the criterion as per (c) in its tier 2 recommendations for Part IIIA.

2.21 However, as currently drafted, we consider that there are problems with (c). It tends to reinforce the view that there can be a substantial market power with respect to a service irrespective of the market definition. This would readily fit with the ACCC's view that there is substantial market power over the service of terminating calls to an operator's subscribers.

2.22 The problem arises because the ACCC does not currently correctly analyse the relevant downstream markets, and the level of competitive constraint in those markets as opposed to a particular service.

2.23 The correct approach under Australian trade practices law is to analyse market power within the context of a market (something that the ACCC did not do in its mobile termination access pricing paper). We recommend that (c) be redrafted along the following lines:

> …by reason of those matters set out in (a), the provider of the service is able to exercise a substantial degree of market power in another market for telecommunication services

2.24 This would align the market power in the downstream market with the bottleneck criteria in (a), in whatever form (a) was drafted. It would focus attention on the level of market power at the retail (or wholesale) level, but not at the access level. At this level, in our view, the market should not be separated into a market for the provision of originating calls and a market for terminating calls. Even if it was, it is doubtful that a mobile operator could be seen to have market power in either market.

2.25 However, a weakness of this draft is that it would only apply to a vertically integrated operator and may not be consistent with the general application of Part IIIA. In this case, an alternative formulation could be in accordance with the PC's tier 1 recommendation:

> "that access (or increased access) to the service would lead to a substantial increase in competition in at least one market, other than the market for the service."

2.26 As discussed earlier, a net-public benefit test should be the overarching criterion in any declaration assessment. We consider that a sensible way to help ensure that this guiding principle is used in practice is to include in the criteria a requirement for the ACCC to be able to demonstrate that the benefits of declaration would most likely outweigh the costs.

Sunset provisions

2.27 Vodafone supports sunset provisions because they are a practical way of protecting against regulatory creep. In dynamic industries such as telecommunications, sunset provisions help to keep the regulatory regime in step with the pace of the market. While it may be appropriate to intervene over an element of the market at one point in time, as the market moves on, this earlier intervention may act to constrain efficiency rather than promote it.

2.28 Regulation in telecommunications markets should always be seen as temporary. Any regulation needs to be regularly reviewed – with the burden of proof on the supporters of regulation to show that continued regulation will result in net public benefits.

Appropriate timeframe for a sunset clause

2.29 The appropriate timeframe would almost certainly depend on the nature of the service in question.

2.30 The regulators in Canada and the Netherlands have imposed a five-year sunset on the local loop service where there is a reasonable prospect of alternative infrastructure in the future: that is, principally in major CBD areas. Outside these areas, these regulators have not imposed any sunset on the service.

2.31 Both the New Zealand Commerce Commission's *Business Acquisition Guidelines* and the ACCC's *Merger Guidelines* provide that the period in which likely competitive entry is considered to be a constraint on present markets is two years. This may suggest that an appropriate sunset clause would be two years prior to likely competitive entry. However, the difficulty inherent in predicting new entry and the tendency for these predictions to slide may invalidate this advance in any sunset clause.

2.32 Most other regulatory regimes of which we are aware have about a five-year implicit review period, eg gas, electricity, and airports (although, generally this is a review of the relevant access arrangement and not whether they are subject to any regulation at all.) In some transitional circumstances this review period is shorter. However, all those sectors are much less dynamic than telecommunications and the review periods in those sectors could represent an outer limit for telecommunications.

2.33 Given this, we propose a maximum sunset period of three years. A two-year maximum is not likely to be credible in relation to the local loop as it would be seen to lead to repeated and costly reviews.

Practical arrangements for sunsetting existing declarations

2.34 The Draft Report is unclear how existing declarations would be treated in terms of the proposed sunsetting provision. However, there is no reason why existing declarations should be treated any differently than new declarations. Indeed, given the range of problems that has been identified in the existing declaration rationale, there are good reasons to adopt a fast-track review of all existing declarations so that they can be re-examined under the new regime.

2.35 We propose the following for existing declarations:

- a provision be inserted in s.152AL which provides that all declarations in respect of services declared under that section as at a certain date, say no more than two years from the date of the legislative amendments, are to be revoked;

- a further provision be inserted in s 152AL which requires that the ACCC in declaring a service under s 152AL(3) to include an expiry time of no more than three years from the date of commencement of the declaration;

- the ACCC would be able to re-declare a service, but only on the application of the revised declaration criteria;

- that all current arbitrations that have not been determined at the time of revocation are terminated, unless the service is subject to a renewed declaration. (This could be by way of an additional provision in s.152CS, to the effect that the ACCC must terminate the arbitration if the service is no longer declared).

- that all existing final determinations cease to have effect from the time of the revocation of the declaration, unless the service is subject to a renewed declaration. (This could be by way of an additional provision in s.152DN).

2.36 This would make existing declarations subject to an immediate sunset clause of two years.

Access holidays

2.37 Vodafone does not consider that Access Holidays would be beneficial, nor that they are necessary under the PC's proposed new declaration criteria.

2.38 The proposed criteria provide for an objective assessment, rather than a subjective assessment of any new service. It is unlikely that any new services would be declared immediately under the new criteria. It is difficult to envisage new services that would immediately be of national significance, economically infeasible to duplicate, and with no available substitutes.

2.39 In the rapidly evolving telecommunications market a declaration should not be made until all the above criteria have been established. It cannot be made on a subjective assessment that they merely *may* be established.

Other issues

2.40 Vodafone supports the PC's recommendation that if a service has expired or is of residual importance, that declaration can be revoked by the ACCC without a full public inquiry. This change would help reduce the risk of regulatory creep and streamline what would otherwise be a clumsy process for undeclaring these types of services.

3. Access : Institutions and Processes

Access seekers and providers

3.1 Commercial negotiation should always be the preferred option. The arbitration process should only be used as a last resort. We agree with the PC that any asymmetric provisions that advantage either the access seeker or provider over the other should be avoided. Although we are not aware of any practical examples, the circumstances identified by the PC provide incentives to either the access seeker of provider to game the process. As such we support recommendations 9.5 and 9.6.

Undertakings

3.2 Undertakings cannot be examined in isolation from both the access code provisions and the service declaration regime. More flexibility is desirable, given the range of situations that may confront a regulator. We propose a regime where:

- an access code can be submitted by an industry body at any time, and
- an undertaking can be made at any time, provide it is not inconsistent with a current access code.

3.3 This would provide an access provider the ability to submit an undertaking either before or after a service has been declared. Neither scenario should be prevented. An accepted undertaking (or even a refused undertaking) provides more certainty to both access providers and access seekers.

3.4 The advantage of an industry agreed access code should not be underestimated. The TAF access code provides a useful framework for any bilateral negotiations, and in turn reduces the requirement for access undertakings.

3.5 Regarding the processes for the review of undertakings, the effect of a determination and acceptance of an undertaking may be the same. Therefore the process and scope of a review of undertakings should be aligned with those that apply to final determinations in order to remove the current potential ambiguity identified by the PC.

Multi-party arbitrations

3.6 Vodafone considers that class arbitrations only make sense in a limited range of circumstances. They would only be superior to bilateral arbitrations if agreed by the group of access seekers, *and the access provider*. However, if this agreement is not forthcoming then any bilateral arbitrations involving disputes with a degree of commonality should be run in parallel, with a focus on eliminating any duplication of resource and effort by the arbitrator, the access seekers or the access provider.

3.7 Any arbitration will generally have some unique circumstance. This may be true even if the service underpinning a series of disputes or the access provider is common. For example, one of the first things an arbitrator would be interested in is a chronology of events leading up to the dispute. This is not something which is normally shared among any parties beyond those that are party to the dispute. Other factors to take into account include:

- Different proposals may have been discussed between the parties. They may involve differences in pricing, timing or structures. They would normally be commercially sensitive and not disclosed to third parties; and

- It is unlikely, given normal commercial negotiations, that all access seekers would have the same viewpoint. Conducting an arbitration with multiple viewpoints could be more problematic and ultimately inefficient compared to parallel bilateral arbitrations.

3.8 It is not clear whether there is a presumption that any determination from a class arbitration would apply equally to all parties, or whether there would be scope to make different determinations in relation to different parties. A presumption that a single determination applying to all parties would be satisfactory is flawed. Different circumstances may apply to different access seekers (or access providers) that may require a different outcome. A simple example would be where one access seeker had a single point of interconnect, where another access seeker had multiple points. If a class arbitration resulted in different determinations for different access seekers then it would have been better to conduct multiple bilateral arbitrations in parallel.

Non-binding indicative time limits on arbitrations

3.9 Vodafone considers it counterproductive to legislate for indicative time limits for arbitrations. Each arbitration must be considered on its merits; some will take longer than others because of their complexity. Even with similar types of arbitrations (such as those for the same service) there are likely to be unique aspects to each individual case that may impact on the time it takes to conclude.

3.10 As guidance to the parties to any arbitration, it may be useful to direct the ACCC to issue an indicative timetable it envisages will enable it to conduct the relevant elements of the arbitration. It may assist the industry if the ACCC distributed such a timetable more widely than the immediate protagonists.

Disclosure of information from previous arbitrations

3.11 The current arbitration process could be streamlined and made more efficient. Vodafone supports the ACCC using to the greatest extent possible any information it has gained from previous arbitrations. However, we would not support giving the arbitrator a unilateral power to determine what is and what is not commercial-in-confidence. If a party claims a piece of information is commercial-in-confidence then it should be treated as such. We believe that current processes provide the ACCC with the opportunity to share their thinking with regard to confidential pieces of information with a relevant party without needing to disclose the actual content. We do not believe a specific power is warranted.

Updating determinations

3.12 There should be no need to update final determinations. The dynamic nature of the industry means that a simple 'glidepath' approach risks significant damage to investment incentives.

3.13 Sunset clauses and streamlined arbitration processes will address many of the problems with the current system.

Improved transparency

3.14 We support efforts to provide greater incentives to pursue commercially negotiated outcomes. One way to achieve this is to provide access seekers and providers with more information about the likely outcome of an arbitration if one is taken to the ACCC.

3.15 In isolation, the publication of reference prices may not provide better outcomes in the market. However, the careful use of them, in combination with greater public disclosure of the ACCC's thinking with respect to the likely outcomes of arbitrations for declared services, may provide parties with sufficient information to conclude commercial outcomes. However, there is a fine balance to be made between providing guidance to parties to aid in commercial negotiations and direct regulatory price setting.

3.16 It may be beneficial to provide the ACCC with greater flexibility to share selected information with parties outside of the bilateral arbitration. However, the extent of such information sharing should be prudently managed.

3.17 A good example of this is the public release of the ACCC's reasoning for not accepting Telstra's PSTN undertaking. Rather than just providing a simple 'no' to the undertaking, the ACCC provided substantial information on the ACCC's thinking behind its decision. A similar approach could be taken for arbitrations.

Appeals

3.18 We consider that merit appeals are a critical element of natural justice. Declarations are a highly interventionist regulatory response that can have potential large commercial impacts on access providers (as well as access seekers). Given the significant risks of regulatory intervention (as outlined in the Draft Report in section 2.5), we consider it prudent to err on the side of caution when contemplating changes to the merit appeals process. When looking at marginal cases, it is better to err on the side of not regulating - given the large costs involved of regulating when it is not warranted.

3.19 We propose that parties should be able to appeal against declaration decisions by the ACCC. However, parties should be prevented from appealing decisions by the ACCC to not declare a service. Structuring merit appeals in this way provides a practical method of applying this bias in order to minimise regulatory overreach. If, after full consideration in accordance with the public benefit test, no case for declaration has been made then it is undesirable to engage further industry resources and create further uncertainty by allowing a merit appeal.

Backdating and Final Offer Arbitration

3.20 We consider that backpayments should remain unspecified and treated on a case by case basis. The case for backpayment will depend on the nature of the arbitration. Each arbitration must be conducted and judged on its own merits. This principle must apply to any backdating of the final determination and subsequent backpayments by either party.

3.21 Different arbitrations will require different resolution. One important factor influencing the backdating or otherwise of a final determination is the ability to pass on higher or lower access prices through to retail prices. Suppose the arbitrator made an interim determination of a low access price but the final determination was a higher price. If the lower initial price is passed on to end-users, then the access provider gets some benefit due to increased volumes (due to the lower price). Vodafone would not support a principle which meant that the final determination had to be backdated to the time of the interim determination, or even earlier, when there is no chance (and neither should there be) of recouping the higher access charges through higher retail charges.

3.22 Backdating will often disadvantage an access provider. This would occur when a lower access price has been determined for a period, but that lower price has not had a chance to be passed through to end-users for the same period. The exception to this is when competition (or specific regulatory intervention) has forced an access seeker to accept a lower price during that period. The arbitrator should be free to judge such circumstances on their merits (but in accordance with the relevant principles) rather than in accordance with some calculation rule.

3.23 The previous example becomes starker if the final determined price was actually an increase on the previous commercially struck rate (this may occur if say higher spectrum prices need to be factored in). It would be unfair if these higher prices were automatically backdated since the access seeker has no chance to recover those increased costs from their customers.

3.24 We do not support final offer arbitration. It is untested and appears inappropriate for the complex set of commercial negotiations in a telecommunications context.

4. Access Pricing

Legislated pricing principles

4.1 As discussed above, even with the new declaration criteria, there is scope for a wide range of services to be declared unnecessarily (eg. mobile access).

4.2 The pricing principles suggested by the PC have a heavy focus on cost based approaches. The ACCC has demonstated a willingness to consider non-cost based approaches in recent declaration reviews (e.g. GSM Termination and Non-dominant PSTNs). We consider that retail minus and benchmarking approaches may be preferable to cost based approaches in some instances. The risk of legislating a set of pricing principles is that it will restrict the ACCC from adopting a more flexible pricing approach for some services.

4.3 The benefits of legislated pricing principles accrue when it is reasonably clear that only a narrow range of services would ever be at risk of declaration. However, the recommended approach already provides opportunities for a significantly wide range of services to be declared. Therefore the introduction of a legislated pricing principles approach will be too restrictive for the ACCC in practice. For example, a pure cost-based approach to mobile termination would not be appropriate, given its complexity and the nature of the service.

4.4 In addition, the emphasis on cost-based pricing may be inconsistent with the declaration criteria, which are designed to promote overall efficiency. The pricing principles may be inconsistent with the declaration criteria in circumstances in which overall economic efficiency is achieved by means other than cost-based pricing.

4.5 If the PC wishes to pursue a legislated pricing principles approach, we propose that the principles should put a greater focus on overall economic efficiency. For example, the principle that prices should "not be so far above costs as to detract significantly from efficient use of services and investment in related markets" should be replaced by the principle that prices should "promote economic efficiency including the efficient use of services, efficient investment in infrastructure and investment in related markets".

Telecommunications pricing for mobile access

4.6 The PC is seeking feedback on the best way to apply regulatory oversight to perceived problems in the mobile access market (particularly fixed to mobile termination rates).

4.7 Our view is that mobile access should never have been declared in the first place. Because the service was 'deemed' under the 1997 legislation, it did not need to go through a formal declaration review. If such a review has been carried out, our view is that the service would not have been declared.

4.8 As discussed above (and in numerous submissions to the ACCC), we consider that there are effective countervailing forces that mitigate any theoretical market power that individual mobile carriers may possess to charge inefficiently high termination rates. We do not agree with the ACCC's view that 'multiple bottlenecks' exist for the supply of a mobile termination service.

4.9 Our view is that if there is any problem in that market it exists in the lack of pass through of lower termination rates to lower fixed to mobile retail rates. We consider that the problem has come about due the structure of the pre-selection service combined with the relative newness of the competitive market. We

expect greater competitive pressure in this retail market, as consumers become more aware of the retail choices available and as higher mobile penetration provide opportunities for consumers to substitute mobile-to-mobile calls for fixed-to-mobile calls (which are in many cases cheaper).

4.10 Price monitoring, as an alternative to declaration, appears attractive as it offers a regulatory intervention that may be more aligned to the nature of the problem. However, the first best solution is to remove the regulatory threat from the mobile services market. The problem with the PC's approach is the lack of detail of how it would work in practice.

4.11 We consider that 'glidepaths' are a clumsy and unnecessary regulatory intervention to apply to the mobile industry. Glidepaths only make sense if it is considered that the perceived 'problem' in the market will endure and that the initial declaration will become quickly outdated. As discussed above, we consider that the rationale for regulation is not supported by any evidence of a problem in the market place.

4.12 However, we agree with the PC that linking the 'glidepath' to the operator's retail prices will result in significant adverse outcomes. We consider a better alternative would be to monitor prices in the market and use this information to aid in any arbitrations that may occur.

Workable pricing principles for terminating charges in two-way access contexts

4.13 In normal situations Vodafone is not convinced there is any need to develop principles to deal with terminating charges in two-way access contexts. We believe commercial outcomes will prevail in reciprocal situations. To the best of Vodafone's knowledge there has never been a problem negotiating access charges between mobile networks.

4.14 We would expect a similar situation in the case of fixed wire networks, unless a particular network is providing a different type of service, or has a different call case profile. For example if one network was predominantly low volume calls to many customers and the other was high volume traffic to a few customers (the call sink scenario). In this case two-way access principles would not be appropriate, however this not to say that commercial outcomes should in any way be unexpected.

4.15 It is more likely that commercial outcomes will be more difficult to achieve in situations involving pre-selection. That is, traffic is in one direction only (or severely loaded in a particular direction). It is this regulatory intervention, maybe

for good reason, which creates the regulatory gaming opportunities that drive disputation over commercial resolution. It may be further exacerbated by additional intervention in the form of price caps.

Retail price controls

4.16 Vodafone agrees with the PC that retail price controls should be removed. The current arrangements create significant distortions across the industry, including a competitive bias against mobile services (and towards fixed services). There are more efficient ways of achieving the Governments social objectives such as providing direct subsidies to targeted groups in society (funded out of general taxation revenues).

Public disclosure of costing methodologies

4.17 Vodafone supports any efforts to encourage commercial negotiation. However, in the event that commercial negotiations break down, it is sensible to examine ways that the current arbitration process can be made more efficient. The public disclosure of the ACCC's thinking in particular arbitrations should enhance both these circumstances.

4.18 However, not all arbitrations are likely to be resolved by reference to costing methodologies.[8] Depending on the particular arbitration, there may be other aspects of the ACCC's thinking that it may be useful to share with the rest of the industry. Hence, the ACCC should be given flexibility to disclose a broad range of information about its method.

5. Carrier Licence Conditions

Industry Development Plans

5.1 We no longer consider that the Industry Development Plans (IDP) serve a useful purpose. We believe that as the industry has become more competitive and as new players have entered, the IDP process has turned into a compliance issue. In today's intensely competitive environment, we consider that market forces are more important than IDPs as a driver of industry development.

[8] Although costing issues are likely to be the most important issue in most cases.

The Facilities Access Regime

5.2 We recommend the scrapping of the current industry-specific regime for facilities access. However, we see problems in adopting the PC's approach of placing facilities access under the general telecommunications access provisions of Part XIC.

5.3 The main problem with the PC's approach is the likelihood that many current (and future) providers of facilities will not be covered under Part XIC of the Act for the simple reason that they are non-carriers. As the telecommunications industry has developed we have seen more and more instances of non-carriers owning towers used in conjunction with supply of telecommunications services For example, Crown Castle (a telecommunications infrastructure owner) has recently taken ownership of a large number of cellsites and towers from Vodafone and Optus. We consider that the trend towards non-carriers taking over ownership and management of telecommunications infrastructure will become more pervasive.

5.4 One of the likely benefits of greater non-carrier ownership is that these companies will have strong incentives to promote infrastructure sharing. This is likely to reduce capital costs across the industry and reduce the risks of anti-competitive behaviour (which presumedly was one of the major reasons for a specific access regime in the first place).

5.5 In contemplating change to the regime, we think it is sensible to have regulation of facilities access controlled by one agency (ACCC) rather than two (ACA and ACCC). However, instead of transferring the regime to Part XIC, we suggest that these facilities should more properly come under general access provisions of Part IIIA of the TPA.

5.6 Having sector specific regulation has the capacity to distort the asset ownership structure within that industry. Whether there is a case for facilities to be declared is problematic. However this should be tested under Part IIIA, not sector specific regulation.

6. Carrier Pre-selection

Multi-basket preselection

6.1 Vodafone suggests that regulatory intervention is not required in this area of the market. The dynamic nature of the industry means that not only are market shares continually changing but so are the distribution of services. At the same

time new access services such as LMDS and DSL are beginning to be rolled out. In this environment it would be very difficult and risky to judge that the long-term benefits of regulatory intervention would outweigh the long-term costs.

6.2 We considered that the outcome of multi-basket pre-selection when it was first introduced would be to split domestic long distance from international long distance. However, fixed-to-mobile calls were subsequently added to the single pre-selection basket. Given developments in the mobile market (higher penetration) and the apparent lack of 'pass through' of lower termination rates to the retail 'fixed-to-mobile' market, it may be more logical to split pre-selection into two baskets: long distance and 'fixed-to-mobile'.

6.3 This is likely to bring immediate benefits to fixed-to-mobile callers. However, these benefits may be of only a short-term nature. Pre-selection service providers would have to focus more closely on fixed-to-mobile pricing. Vodafone has already presented evidence to the ACCC that declines in mobile terminating access prices have not been reflected in the retail price of fixed to mobile calls.

6.4 However, in the longer term Vodafone believes any immediate shortcomings will be competed away. As long distance and international prices continue to fall, and mobile penetration continues to rise, pre-selection service providers (and alternate access providers) will be forced to focus on their fixed-to-mobile pricing as it continues to grow as a proportion of a customer's total fixed service budget.

Restricting pre-selection obligations to Telstra

6.5 We consider that 'pre-selection' as a service should be required to pass the new declaration criteria. This would focus regulatory intervention on areas of durable market failure and restrict regulatory intervention to services provided by facilities that were not feasible to duplicate.

6.6 Given the current regulatory arrangements surrounding pre-selection, it is likely that there would be a number of practical difficulties in moving to our preferred approach (ie. how would current customers using pre-selection with non-dominant providers be managed?). We have not developed any practical transition arrangements but would welcome an opportunity to provide feedback on any practical approaches developed by the PC.

7. Universal Service Arrangements

7.1 We disagree with the PC's recommendation that the power to determine the aggregate service levy should lie with the ACA, rather than the Minister. The lengthy and complex history of the determination of the National Universal

Service Cost (NUSC) amount provides practical evidence of the importance of ministerial involvement.

7.2 As indicated in the Draft Report, following Telstra's initial claim of a NUSC amount of $1.8 billion for 1997/98, the Parliament passed legislation to cap the amount at $253.32 million. The Minister could have determined an amount himself, but chose (presumably because of their importance) to refer his conclusions to the scrutiny of the Parliament.

7.3 Further, in assessing the NUSC amounts for 1998/99 and 1999/2000, the ACA explicitly decided to refer their finalisation to the Minister, stating that this was a matter of Government policy consideration:

> It is my view that a decision on this matter is a Government policy consideration, as the appropriate costing approach can not be derived or implied from the Telecommunications (Consumer Protection and Service Standards) Act 1999, which provides the basis of the calculation of the NUSC.[9]

7.4 Determining a wrong NUSC amount could have had serious consequences for consumers and industry alike. On the first occasion the Minister chose to refer it on to the Parliament, and on the second occasion the ACA highlighted there were important policy considerations that only the Minister could determine.

7.5 In essence we urge a cautious approach to arrangements in the short term. Australia is at the leading edge of pioneering new approaches to universal service provision (eg. the USO Contestability Pilots) and flexibility should be retained in determining universal service levy amounts to maximise the prospect of success.

7.6 On other matters raised by the PC, Vodafone does not support a market based tendering process for encouraging competition in the provision of universal service. Rather, Vodafone supports the USO Contestability pilot trials already announced by the Government, as being the most practical strategy for testing ways of improving the delivery of universal services in rural Australia.

7.7 There have been nearly three years exhaustive debate and analysis surrounding USO arrangements, initiated by the lodgement by Telstra of its $1.8 billion NUSC claim for 1997/98. This has involved extensive consultation across the industry, the production of numerous discussion papers, a Senate inquiry, legislation and consideration of alternative USO models (including the tendering approaches outlined in the Draft Report).

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[9] A J Shaw letter to Senator the Hon. Richard Alston, 19 January 2000.

7.8 The outcome of this process has been the adoption by the Government of the USO Contestability model. To open up the whole issue again for further consideration would require the allocation of scarce, costly resources to yet further theoretical debate. In Vodafone's view it is time for the selected model to be properly tested, as proposed by the Government, rather than to cause further delay in improving universal service delivery by re-examining alternatives that have already been put to one side. Further delays could also assist the incumbent universal service provider entrench its position.

7.9 The merits of the Government's model are compelling:

- Consumers get a choice of universal service provider (assuming the subsidy is sufficiently high to make the supply of the service commercially attractive to Competing Universal Service Providers (CUSPs))

- Consumers get a choice of USO service package (assuming there is more than one universal service provider)

- A USO service package will exceed the minimum universal service obligation (assuming CUSPs will enhance the basic service in order to win a consumer's custom)

- CUSPs can adapt their USO package to particular markets (eg. some consumers may be attracted to a package that includes a mobile service option; others to a package that includes a high speed internet access option; and yet others to a package that includes a pay television option)

- To the extent that the subsidy level is set above cost, the consumer will be the beneficiary as CUSPs will be able to afford to enhance their service to attract the customer

- Reliance on incentives, rather than pecuniary penalties, as a means of improving service delivery is a desirable practice

- The more remote consumers might benefit the most. CUSPs may initially be attracted to universal service areas with higher subsidy levels. This would be in the more remote and more sparsely populated areas where existing services may be poor and there may be no existing fixed wireline infrastructure

- The subsidy level need only be set to be sufficiently attractive to CUSPs, without having to be a completely accurate estimate of cost[10]. In this regard the pilot studies will give a practical test of the subsidy levels that have been determined – already the subsidy levels set in the Extended Zones have been judged by tenderers to be sufficiently high

7.10 In summary, the Government's USO Contestability pilots should not increase the overall cost of delivering USO services, could provide consumers with a choice of services tailored to their specific needs and could result in more remote consumers being the most likely to benefit from this initiative.

8. Conclusion

8.1 Telecommunications is a critical infrastructure industry. It is timely to review the specific competition legislation governing the industry given the substantial changes that has occurred since its as original introduction.

8.2 In the past, consumers had limited options for choosing a provider for the majority of its telecommunications services. Now, consumers have a wide range of providers to choose from. In addition, contestable service delivery is occurring for products and services that were once considered uneconomical to be supplied by more than one player. Technology and convergence are challenging the traditional industry model for telecommunications.

8.3 Over the next few years competitive forces will continue throughout the industry, driven by new technology and greater convergence between mobiles and fixed (as well as potentially from other industry sectors). This will act to break down traditional competitive 'bottlenecks'. We consider that now is a sensible time to remove industry specific regulatory oversight and instead revert to generic competition law.

8.4 We consider that the Draft Report is on the right track – but further reforms are needed so as to free the industry from the artificial speed limits caused by the current regime.

[10] In fact, this approach will make CUSPs put a value on the 'intangible benefits' of being a universal service provider. This is a benefit that the ACA has been unable to quantify or include in its NUSC estimates.