Initial Submission by Telstra Corporation Limited on the Productivity Commission's Draft Report on Telecommunications Competition Regulation

May 2001

Contents

1. Introduction

Telstra Corporation Limited ("Telstra") welcomes this opportunity to put its views to the Productivity Commission (the "Commission") in response to the Commission's Draft Report on Telecommunications Competition Regulation dated March 2001 (the "Draft Report").

The objective of this initial submission is to provide the Commission with Telstra's preliminary responses to certain of the recommendations and requests for information that are contained in the Draft Report, with the aim of providing where applicable practical solutions for improving and implementing the recommendations. Telstra aims to provide a more detailed submission to the Commission by 1 June 2001.

1.1 Summary of Telstra's preliminary responses

The following summarises Telstra's preliminary position on the issues discussed in this submission:

- Telstra reiterates the importance of considering the current regime and any changes to that regime, not only in the context of current market conditions, but also with a view to the myriad technological and market developments going forward. In particular, it is critical that the review restructure the current regime such that it provides incentives for efficient investment over the next few years and beyond;

- to this end, Telstra is examining a number of procedural changes that if implemented could help provide the additional certainty investors require if they are to continue to fund the development of Australian telecommunications infrastructure. These changes could include the use of effective safe-harbour provisions in the access regime that would allow the regulator, prior to an investment being made, to issue an opinion as to whether or not the declaration criteria would be satisfied. Similarly, procedures – such as evidentiary notes and regulatory contracts – could be introduced to allow an investor subject to access regulation to obtain increased levels of certainty on how access prices will be determined prior to the investment being made;

- Telstra welcomes the Commission's recommendation with respect to the future of the telecommunications-specific competitive conduct rules. Telstra's preferred outcome is also for outright repeal of the rules in Divisions 2 and 3 of Part XIB of the Trade Practices Act 1974 (Cth) (the "TPA"). In Telstra's view,

these rules are an impediment to genuine competition and their continuation cannot be justified;

- Telstra welcomes the Commission's strong support for greater convergence between the declaration criteria contained in Parts XIC and IIIA of the TPA and acknowledges the efforts of the Commission in seeking to bring greater clarity to these criteria. Telstra is, however, concerned that the proposed changes to the Part IIIA criteria have the potential to increase regulatory uncertainty. Instead, Telstra recommends that the Commission consider importing the current Part IIIA criteria into Part XIC, with only slight modifications to deal with the issue of non-dominant networks;

- Telstra supports the Commission's draft recommendation to sunset the existing declarations. No declaration should last more than three years. A declaration of a service that has been in force for more than three years should be revoked unless the regulator can demonstrate that the statutory conditions for declaration of the service continue to hold;

- Telstra is concerned that the Commission has considered it inappropriate to extend the scope for appeal to the Australian Competition Tribunal. Telstra submits that the Commission should view the extension of merits appeal rights on decisions to declare a service or not to revoke a declaration as an effective constraint on regulatory over-reach;

- Telstra is similarly concerned that the Commission has considered it inappropriate to recommend that the National Competition Council be given responsibility for the declaration decision under Part XIC, as is the case under Part IIIA. Telstra submits that institutionalising the distinction between the policy decision (whether to regulate or not) and the regulatory process (on what terms and conditions access should be applied) is an important additional constraint on regulatory over-reach;

- Telstra agrees with the Commission's recommendation that pricing principles be included in the TPA. In this submission, Telstra details a preliminary list of additional principles that it submits will help ensure regulatory access prices are set so as to maintain incentives for efficient investment and improved productivity; and

- finally, in relation to pay TV, Telstra submits that exclusivity arrangements and good content drives platform competition. The real constraints on the development of pay TV competition in parts of regional Australia are the regulatory constraints on efficient investment in alternative delivery platforms.

1.2 Structure of the submission

The structure of this initial submission is as follows:

- Section 2 reiterates Telstra's position on the context within which the telecommunications-specific competition regime should be reviewed;
- Section 3 details Telstra's preliminary suggestions on procedural reforms that would help provide the certainty investors require if they are to continue to invest in telecommunications infrastructure;
- Section 4 details Telstra's position with regard to the proposed repeal of Part XIB and the proposed reforms to Part XIB as an alternative to repeal;
- Section 5 details Telstra's response to the key Commission recommendations with regard to the declaration of services under Part XIC;
- Section 6 details Telstra's response to the Commission's proposal to incorporate legislative pricing principles into Part XIC; and
- finally, section 7 sets out Telstra's position on the proposed regulation of regional pay television services.

Each section adopts, where appropriate, the approach of briefly summarising:

- the Commission's relevant recommendations and analysis, as well as its requests for information (where relevant to the discussion in this initial submission); and
- Telstra's views in response, as well as any information Telstra is able to provide which may assist the Commission in its deliberations.

As noted above, Telstra aims to provide a more detailed submission in response to the Draft Report by 1 June 2001. In the meantime, Telstra looks forward to having the opportunity to discuss its views at the public hearings commencing in the week of 14 May 2001.

2. Approach to telecommunications regulation

The Commission, in considering the current telecommunications-specific competition regime and making recommendations for change, should adopt a forward-looking approach. That is, it should ensure that the benefits of a vigorously competitive telecommunications market are achieved by recommending reforms that will position the industry to address the dynamic changes it will face over the period 2003-2005.[1]

In addressing these considerations, Telstra submits that the Commission should do this, not only in the context of current market conditions, but with a view to the myriad technological and market developments going forward. Such an approach is imperative in order to ensure that Australian consumers and businesses reap the maximum benefits possible from the full liberalisation of the Australian telecommunications market and technological developments within the industry.

Sections 3(2)(c) and (d) of the Telecommunications Act 1997 (Cth) states that the objects of that Act include promoting:

(a) the supply of diverse and innovative carriage services and content services; and

(b) the development of an Australian telecommunications industry that is efficient, competitive and responsive to the needs of the Australian community.

These objects are important because their achievement is critical to Australia's success as an information-oriented, internationally competitive economy. However, much of the debate that has surrounded the Productivity Commission's review of telecommunication regulation has centred on gaining access to existing infrastructure. This however, ignores the critical role investment will play in delivering the objectives of the telecommunications policy and the Telecommunications Act. If telecommunications policy focuses its attention of accelerating access to existing infrastructure at the lowest price, then it could seriously place in jeopardy future investment in new infrastructure.

Investment in efficient new telecommunications infrastructure is the most important factor in ensuring that Australia continues to reap the benefits of the digital age. Such investment is important for at least two principal reasons:

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[1] In Telstra's view, a four-year time frame is an appropriate point at which to reconsider again the telecommunications-specific competition regulatory regime. A longer time frame than this is clearly fraught with predictive dangers.

(a) major demands are being, and will continue to be, placed upon Telstra to undertake a complete upgrade of its exiting copper network in order to meet the increasing service quality standards imposed by consumer expectations and regulation;[2] and

(b) technological changes (which in turn drive service innovation) have meant that the network of the future is constantly evolving and changing. Further, in a time of rapid technological change the investment environment is highly uncertain both for the industry and for end users. In various parts of Australia, the most efficient access network(s) of the future will not already be in place. New technologies and new infrastructure will be needed.

The current regulatory regime presents a number of features that seriously undermine and distort the incentives of all players to undertake efficiency-enhancing investment, including in competing technologies.

This can readily be observed in the current market. Although the central feature of today's telecommunications markets is that they are intensely competitive,[3] vigorous rivalry is observed only in those industry segments where regulatory distortions do not prevent competition from developing.

For example, it has been seen to date that the provision of regulated access on uneconomic terms has dulled the incentives for facilities-based, local loop competition, virtually eliminating investment by Telstra's competitors in all but a select number of segments (namely, the low-cost CBD areas of the major capital cities and in the largely unregulated area of mobile services). Furthermore, uneconomic access demands make Telstra's continued investment in the core network ever more marginal, thus threatening the long-term sustainability of the Australian telecommunications industry.

If the aspects of the current regulatory regime that distort incentives to invest in new technologies and infrastructure and deter the development of competing networks are

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2 See, for example: *Connecting Australia*, Report on the findings of the *Telecommunications Service Inquiry*, September 2000.

3 This is discussed, particularly, in Section 1 of Telstra's first submission to the Commission's present inquiry: Telstra, *Submission to the Productivity Commission Inquiry into Telecommunications Specific Competition Regulation*, 9 August 2000 (the "First Submission"), See also report of Professor Ordover (*Effective Telecommunications Service Competition in Australia and the Need for Regulatory Reform*, 26 November 2000) submitted by Telstra.

not corrected in the immediate future (for example, uneconomic access prices), Australia is at serious risk of being locked into old, inappropriate technologies for the contemporary age. This means that Australian consumers and businesses, regardless of their geographic location, will not be able to take advantage of those emerging, innovative services that demand new technology platforms.

Accordingly, in considering reforms of the telecommunications-specific competition regime and finalising its recommendations for change, Telstra strongly urges the Commission to ensure that that regime maximises the potential for Australian consumers and businesses to benefit from the emergence of new, innovative services. The Commission can achieve this by ensuring that the telecommunications-specific competition regime is reformed such that it improves incentives for efficient investment over the next few years and beyond.

3. Increasing regulatory certainty

As discussed in section 2, Telstra submits that it is critical that the Commission, in considering reforms of the telecommunications-specific competition regime and finalising its recommendations for change, seeks to ensure that the regime provides the right incentives for efficient investment and ongoing improvements in productivity if Australian consumers and businesses are to benefit from the emergence of new, innovative services.

To date, Telstra has emphasised the importance of repealing Part XIB and getting the declaration and determination processes under Part XIC correct as the primary means for ensuring incentives for efficient investment are retained. At the end of the day, the extent of the access regime and the level of access prices will have a determinative impact on investment decisions. For this reason, the following sections of this submission comment on the Commission's key recommendations that go to these very important issues.

This section of the submission, however, stresses the importance of reducing the levels of uncertainty as to procedures that are associated with access regulation under Part XIC and details a number of preliminary procedural solutions that could operate to reduce this uncertainty.

3.1 Sources of regulatory uncertainty

One of the biggest regulatory hurdles to investment that characterises Part XIC is the lack of regulatory certainty prior to investment. Specifically, investors lack certainty as to:

(a) Whether or not their proposed investment will come within the purview of Part XIC; and

(b) If so, then, on what terms and conditions access will be mandated.

Telstra, for example, faces a high degree of uncertainty when rolling out such significant investments as the CDMA mobile network and the ADSL service as to whether or not the Australian Competition and Consumer Commission ("ACCC") will declare the services provided by such investments. The current legislation provides absolutely no mechanism for Telstra (or any other investor) to assure itself *ex ante* that Part XIC will not apply to a proposed investment.

Moreover, even if there is some degree of certainty that a particular investment will be captured by the provisions of Part XIC – for example, it is an investment in a service that

is already declared – there remains significant uncertainty as to how the regulator will price access to the service provided by that investment. Under Part XIC as implemented to date, there is no certainty as to the pricing methodology that will be employed (TSLRIC v retail-minus), whether or not the assets will be exposed to risk of regulatory stranding, the depreciation rates that will apply, the cost of capital that will be imputed etc. Moreover, there is no guarantee under Part XIC that the ACCC will not change its position over time on any of these issues, despite the fact that changes in any of these parameters can make the difference between recouping the costs of an investment or making a loss.

Telstra submits that this uncertainty is an unacceptable feature of the current regime; a feature that impacts negatively on investment decisions and that should be reformed immediately.

3.2 Safe harbours

In Telstra's view, and consistent with the move towards greater alignment with general competition law, increased certainty as regard the declaration decision under Part XIC could be achieved by developing a process akin to the authorisation/notification and informal merger clearance procedures that operate under the TPA at present.

For example, one process might be to enable a prospective investor to request a binding opinion from the ACCC (or alternatively the NCC if it were to assume responsibility for declaration under Part XIC) as to whether or not the criteria for declaration are satisfied in relation to a proposed investment. The ACCC/NCC would then be obliged to consider that request and either:

(a) issue an opinion as to whether or not the declaration criteria were satisfied; or

(b) issue a statement that it was not in a position to make an assessment as to whether or not the declaration criteria would apply based upon the material provided to it by the prospective service provider.

Any opinion provided by the ACCC/NCC would be binding on the ACCC/NCC in any future application for declaration of the asset except where:

(a) information provided to the ACCC/NCC by the prospective service provider was, at the time it was provided, inaccurate or reasonably ought to have been known by the prospective service provider to be inaccurate; or

(b) there is a material change in circumstances, the onus of proof of which is on the ACCC/NCC.

Clearly there are some issues regarding timing and certainty that operate in the general competition law at present. Nonetheless, Telstra considers that there is scope to derive a process that overcomes those concerns and provides sufficient certainty for potential investors in long-lived assets. Telstra would welcome the opportunity to explore with the Commission in more detail the possibilities for such a safe harbour process.

3.3 Evidentiary notes and regulatory contracts

Similarly, procedures could be introduced to allow the investor to obtain increased levels of certainty prior to the investment being made on how access prices will be determined.

One option to provide greater certainty *ex ante* as to the facts that will be relied upon in arbitrations or assessments of undertakings, would be a system of evidentiary notes, whereby the regulated firm details *ex ante* a number of the features of the proposed investment (e.g. total expenditure, anticipated asset lives, anticipated additional capacity available to access seekers etc). This could be undertaken on a confidential basis, as the regulator would not be required to adjudicate the information provided, although it would need to be audited. The regulator would simply be required to expeditiously accept or reject the information as prima facie reliable. It would then be required to have regard to this evidence in future access disputes and would face a significant evidentiary burden if it planned to dispute or disregard these facts when setting regulatory access prices.

Clearly, this procedure will not be appropriate for all classes of investment, particularly investments involving substantial risk, where greater certainty is required *ex ante* about the terms and conditions of access to the service. It has the advantage, however, of being presumptive of the facts contained in the notification and avoiding substantial delay and public disclosure of the commercially sensitive information.

An alternative option for investors who require greater certainty would be a requirement for an explicit regulatory contract between the regulator and the regulated firm. The terms of this contract would be agreed upon prior to the regulated firm making an investment in assets that the safe harbour process, noted above, indicates are likely to be subject to regulated access requirements under Part XIC. Such *ex ante* agreements will allow the regulated firm to undertake more precise financial modelling with a view to making the final decision on whether or not to proceed with the investment. Regulatory contracts could take one of two distinct forms:

(a) A compact between the regulator and the regulated firm on the key regulatory parameters – i.e. *ex ante* agreement on the parameters in the regulatory model that are determined by the regulator such as the beta weights to be used when calculating the weighted average cost of capital, whether or not assets will be

vulnerable to regulatory stranding (i.e. a cost optimization modelling approach used), and if so the circumstances under which this would occur (i.e. how the optimization would be implemented), the period between regulatory resets etc. The regulator will be bound to agree to parameters that are proposed and that are consistent with the legislative pricing principles, subject to a strict material change in circumstances clause; or

(b) An undertaking, which would detail the terms and conditions of access for the lifetime of the asset. Again, the regulator will be bound to agree to an undertaking that was consistent with the legislative pricing principles, subject to a strict material change in circumstances clause.

Were Undertakings to be retained, they would need to be administered to reflect the commercial and time sensitivities of investment planning and future access requirements. Undertakings should take the form of streamlined market inquiries rather than the unwieldy processes that to date have characterised Undertakings via Part XIC. For the Part XIC Undertakings, rather than rely on its own analysis, the ACCC has sourced every conceivable piece of information from every potentially willing source and has then provided all of that information to the world at large. Its subsequent analysis has proved to be slow and cumbersome. When coupled with the ACCC's tendency to socialise its views (including its preliminary views) with the media, the Undertaking process has generated extremely unhelpful (not to mention premature), market expectations.

4. Anticompetitive conduct

This section discusses the Commission's proposed repeal of Part XIB of the TPA[4] and briefly discusses the alternative approach of amendment of that Part.

4.1 Commission's recommendation and analysis

The Commission recommends that the anticompetitive conduct provisions of Part XIB be repealed.[5] The arguments cited in support of this recommendation are principally:

(a) the enhanced opportunity that the relevant provisions of Part XIB create for regulatory error and overreach;

(b) the demonstrated experience of the complexity of administering the relevant provisions of Part XIB;

(c) the cases which have arisen under the relevant provisions of Part XIB are very few, appear minor and would arguably have been more appropriately dealt with under Part XIC;

(d) there are alternative bases upon which issues arising under the relevant provisions of Part XIB may be addressed, including through Parts IV and XIC of the TPA;

(e) the progress of experience under the existing Part XIC, and the potential to improve those processes further through the adoption of other relevant recommendations of the Commission; and

(f) the increase in sustainable competition within the industry, so that there would be no significant effect on competition from the removal of the relevant provisions of Part XIB.

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4 With the exception of those provisions dealing with tariff filing directions and record keeping rules, which will be addressed in future submissions.

5 Draft Recommendation 5.1 (Draft Report at page 5.42).

4.2 Support for repeal

Telstra strongly supports, and welcomes, the Commission's recommendation with respect to the future of the telecommunications-specific competitive conduct rules. Telstra's preferred outcome is also for the outright repeal of the rules in Divisions 2 and 3 of Part XIB and agrees entirely with the Commission's reasoning in that regard.

In particular, Telstra agrees with the concerns expressed by the Commission with regard to the lack of clear regulatory boundaries between Parts XIB and XIC of the TPA. While it is difficult to quantify the costs of the uncertainty associated with such lack of clarity, the interplay between the two regimes imposes a brake on the development of strong competition and dampens the incentives for vigorous competition. This is because the discretion accorded to the ACCC to pick and choose between these sources of power (with little or no accountability for so doing and, in many cases, reduced opportunities for judicial review of the ACCC's decision-making) acts as a shadow on any carrier which might be deemed to have substantial market power intending to engage in strong, pro-competitive conduct.

Telstra has previously discussed, and reiterates, its other major concerns about Part XIB, namely:

(a) the justification for the creation of a telecommunications-specific set of competition rules in addition to that existing under Part IV of the TPA was always, and continues to be, highly questionable.[6] This is particularly the case when the healthy state of competition in the industry is taken into account;[7]

(b) Part XIB has proved entirely unnecessary, as Part IV (and, also, Part XIC) of the TPA provides the ACCC with substantial and sufficient powers to regulate anti-competitive conduct and address competition concerns. Telstra has previously demonstrated this using an analysis of the matters arising under the competition notices which were issued by the ACCC under Part XIB (relating to internet peering and commercial churn), as well as the ACCC's investigations

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6 First Submission, 32-36.

7 Refer Second Submission, 27. See also report of Professor Ordover (*Effective Telecommunications Service Competition in Australia and the Need for Regulatory Reform*, 26 November 2000) submitted by Telstra.

into Telstra's "$3 STD Deal", "Switchports" and the ISDN SPC and DC continuity cases;[8]

(c) Part XIB introduces asymmetric regulation into the Australian telecommunications-specific competition regime, with regulatory impositions being imposed only on firms with substantial market power – in contrast with Part XIC which applies to services rather than firms. As the Commission has noted in the Draft Report, asymmetric regulation has the potential to create significant additional distortions;[9] and

(d) the ACCC's additional powers under Part XIB, and the lack of appropriate procedural and merits review of the use of those powers, creates a significant risk that, if Part XIB is not wound back, much legitimate pro-competitive conduct, investment and innovation will be deterred, causing significant harm to both static and dynamic economic efficiency and short, medium and long term consumer welfare.[10] This is particularly the case, given the highly dynamic nature of the telecommunications industry.

In Telstra's view, the rules in Part XIB are an impediment to genuine competition and their continuation cannot be justified.

4.3 Alternatives to repeal

The Commission has suggested that an alternative approach would be to amend Part XIB to "modify its undesirable features".[11] Although Telstra will discuss the alternative proposals in detail in its full submission, it is worth commenting briefly on the general notion of amendment of Part XIB.

Given the basic rationales in support of the repeal of the relevant provisions of Part XIB, Telstra finds it difficult to understand what sufficient justification might be offered for adopting this approach.

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8 First Submission, 28-31; Second Submission, 30-32.

9 Draft Report, pages 8.28—8.29.

10 First Submission, 29, 32, 36.

11 Draft Report, page 5.1 (refer the extended discussion at pages 5.40-2 of the Draft Report).

Since the introduction of Part XIB of the Act, there have been numerous calls for its amendment to strengthen its provisions and to remedy claimed deficiencies in its operation. Some were heeded (with mostly dubious results in achieving the benefits foreshadowed, as illustrated by the amendment proposals expressed through the passage of the Telecommunications Legislation Amendment Act 1999 (Cth)) – and some were not.

In Telstra's view, the latest calls for amendment of Part XIB should be disregarded also because:

(a) good regulatory policy does not ensue from continually refining legislation until it achieves very specific outcomes tailored for particular self-interests;

(b) this approach fails to recognise that it is not a case of Part XIB merely having undesirable features, but being undesirable *per se*. The reasons for this have clearly been set out above and in previous submissions. Tinkering with odd provisions here and there does not turn bad law into good law; and

(c) the considerable costs imposed by the overlap between Parts IV and XIB, as well as by the uncertain relationship between Parts XIB and XIC, are not avoided by regulatory amendment of Part XIB.

5. Part XIC: Declaration of services

The Commission has recommended that the telecommunications-specific access regime contained in Part XIC of the TPA be retained but be substantially reformed to more closely align Parts IIIA and XIC of the TPA.

Telstra supports this recommendation, acknowledging in its previous submissions to the Commission that there are important transitional issues that 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 that require the regulation of termination charges on all networks, at least for so long as controls over retail prices remain in place.

In the interim, Telstra has proposed significant amendments to the procedures under Part XIC relating to the declaration of services. Telstra's proposed amendments included redrafting the declaration test, introducing sunset clauses, reforming the exemption mechanism, and providing for full merits review. Telstra views these reforms as absolutely necessary to ensure that intervention is strictly limited to the residual areas of market failure.

Telstra therefore welcomes the Commission's proposed amendments to the procedures under Part XIC relating to the declaration of services, summarised by the Commission as follows:

> [The key to reform is to ensure that] the scope of regulations is appropriate — so that arrangements only apply to those core telecommunications services where the case for intervention is strong. Additional layers of regulation — regulatory creep — should be avoided. The current scope of regulation may be too great. While the major bottleneck is local loop services, other services have also come under the regime — such as various trunk services. The Commission:
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> - recommends a tighter set of criteria for declaration that converge on those of the Commission's second tier proposals for the national access regime (Part IIIA). The Commission also recommends that the current objects test (the 'long-term interests of end-users') be broadened to encompass overall economic efficiency, as proposed for Part IIIA. This would maintain consistency between the generic and the specific access regimes and remove possible ambiguity;
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> - floats the option of allowing access 'holidays' that can immunise certain investments from future declaration. These holidays would apply to investments that would be at risk were they to be declared. However, the Commission is asking for feedback about the implementation of such holidays;

- recommends that a sundry set of access arrangements (for example to mobile towers) currently prescribed by licence conditions should be subject to the hard tests imposed by the access regime. Industry Development Plans should be abandoned; and

- recommends that the legislation specify sunset clauses for all declared services, as well as streamlined procedures for revoking declarations to services where access is no longer required.[12]

This section of the submission summarises Telstra's initial responses to these proposals and the accompanying requests by the Commission for information.

5.1 Criteria for declaration

5.1.1 Commission's recommendation and analysis

The Commission considers that the existing declaration criteria in Part XIC:

(c) are excessively vague;

(d) allow too much flexibility for the regulator in deciding when to declare; and

(e) differ in a non-justifiable way from the criteria that have been proposed for Part IIIA of the TPA.

The Commission recommends that, for a telecommunications service to be declared, it must meet all of the following criteria:

(a) the telecommunications service is of significance to the national economy and

   a. for a service used for originating and terminating calls, there are substantial entry barriers to new entrants arising from network effects or large sunk costs; or

   b. for a service not used for originating and terminating calls, entry to the market of a second provider of the service would not be economically feasible;

(b) no substitute service is available under reasonable conditions that could be used by an access seeker;

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12 Draft Report at pages XXVII-XXVIII.

(c) competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;

(d) addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly; and

(e) access (or increased access) to the service would not be contrary to the public interest.[13]

These criteria are similar to the criteria proposed for Part IIIA, although as the Commission notes they differ with respect to the special treatment of originating and terminating services under (a)(a) set out above and the absence of a requirement to waive declaration where there is an alternative effective access regime.

The Commission has specifically invited comments on whether interpretations of the criterion at (a)(a) above may widen the scope of the test excessively and, if so, appropriate ways of narrowing its application.

5.1.2 Telstra's response

Telstra welcomes the Commission's strong support for greater convergence between the declaration criteria contained in Parts XIC and IIIA of the TPA. Telstra believes that the criteria currently set out under Part IIIA are superior to those provided for by Part XIC, exercising a far more effective constraint on regulatory creep. Importantly, Part IIIA details a set of conditions, each of which must be met, rather than factors that must be taken into account but can be traded off. Moreover, the Part IIIA conditions 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 effectively.

Telstra acknowledges the efforts of the Commission in seeking to bring greater clarity to these criteria. Telstra is, however, concerned that the proposed changes to the Part IIIA criteria have the potential to increase regulatory uncertainty. Specifically, Telstra is concerned that:

(a) The expression "economically feasible" is very unclear – how does it differ from "uneconomic to duplicate"?

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13 Draft Recommendation 8.3 (Draft Report at page 8.24).

(b) Similarly, how can an access seeker demonstrate that existing terms and conditions are unreasonable? Does this require some form of *ex ante* determination process?

(c) Finally, the expression "improve economic efficiency significantly" has no meaning under Australian jurisprudence.

Telstra acknowledges that uncertainty has also been a feature of the existing Part IIIA criteria. However, recent case law is bringing much greater clarity to the meaning of expressions such as the "promotion of competition". The *Duke* decision,[14] for example, cited the *Sydney Airport* case[15] approvingly on this notion and utilised the same test. Similarly, the *Sydney Airport* case has made clear what is the appropriate economic test implied by the expression "uneconomic to duplicate".[16]

Telstra recommends that the Commission seek to protect the clarity arising from this growing body of precedent to the greatest extent possible by keeping the proposed changes to any Part IIIA criteria imported into Part XIC to a minimum.

Telstra recognises, however, that some modifications are required to the current criteria – in particular, the "uneconomic to duplicate" and "national significance" tests – to ensure that the non-dominant network problem can be addressed. As Telstra has detailed previously to the Commission, 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.[17] Such so-called non-dominant networks would be very unlikely to meet the Part IIIA criteria as currently drafted.

In summary, Telstra believes that some redrafting of the revised threshold test is preferable to capture access to networks where power imbalances arise as a result of regulatory distortions and to fully utilise the "learnings" under Part IIIA. Telstra would be happy to provide possible drafting adjustments. However, Telstra supports the policy directions of this proposal.

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14 *[citation]*

15 *[citation]*

16 *[citation]*

17 See J. Wright, 2000, 'Non-dominant network competition', www.necg.com.au

5.2 Sunsetting of declarations

5.2.1 Commission's recommendation and analysis

The Commission recommends that, in addition to the existing revocation mechanisms under s152AO of the TPA, Part XIC should include an explicit provision for sunsetting declarations, with a reasonable sunset period to be set at the time of declaration.[18] The Commission also recommends that, where a service has expired or is of residual importance, declaration may be revoked by the ACCC without a full public inquiry.[19]

As the Commission and the ACCC have recognised, the inclusion of sunsetting provisions would reflect the fact that the underlying motivations for declaration of a particular service may vanish in time, with technological change, declaration of substitute services or maturing facilities-based competition.[20]

5.2.2 Telstra's response

Telstra supports the Commission's draft recommendation to introduce sunset provisions for declarations made under Part XIC. As Telstra noted in its previous submissions to the Commission, one of the many procedural features of Part IIIA that minimise the economic costs of its application – particularly in comparison with Part XIC – is the fact that declarations under Part IIIA must be for a defined duration. Depending upon the duration adopted, this can substantially reduce the risk that services remain within the regime well after the factors that justified their initial declaration have disappeared.

If sunset provisions were part of the operation of declarations under Part XIC, then clearly redundant declarations such as mobile analogue termination services would have been automatically revoked. More importantly, the periodic reassessment of declaration decisions necessitated by sunset provisions would also mean that it is unlikely that the current situation where the ACCC has declared services for which alternative services are already declared – and hence regulated access is *prima facie* unnecessary and imposes an unnecessary distortion – would have occurred.

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18 Draft Recommendation 8.4 (Draft Report, page 8.31).

19 Draft Recommendation 8.5 (Draft Report, page 8.31).

20 Draft Report, page 8.29.

The Commission also makes the valid point that "any commercial contracts framed during a period when declaration would have applied should be honoured even if the declaration is revoked. In this context, one of the advantages of sunsetting declarations is that it would provide an incentive for entrants to write longer term contracts with the facility provider — reducing the problem of regulatory risk and stranded assets that besets investment by the incumbent."[21]

Therefore, Telstra supports the Commission's draft recommendation to include an explicit provision for sunsetting declarations under Part XIC.

In relation to the duration of declarations, Telstra submits that the Commission should recommend that all declarations remain in force for a period of no longer than three (3) years. A declaration of a service should be automatically revoked once the sunset period is reached unless the regulator can demonstrate that the statutory conditions for declaration of the service continue to hold.

Telstra submits that the implementation of a uniform sunset period of no more than three years has potentially fewer costs than a case-by-case approach to determining the length of the declaration. Telstra acknowledges that, ideally, each declaration would have a duration set on the basis of an estimate of the time period over which the statutory conditions for declaration of the service are likely to hold. This period is likely to vary significantly across services – for example, much shorter for inter-capital transmission than for the local loop in more remote parts of Australia. However, determining this period *ex ante* with any degree of confidence is impossible as it is usually unforeseeable changes in technology or demand that make a declaration redundant. Trying to determine an optimal period of declaration duration would simply add another layer of uncertainty to the regulatory process, the costs of which are likely to be far greater than the administrative costs associated with periodic reviews of the ongoing applicability of the declaration. The analogy can be drawn with the system of patents where uniform timeframes are adopted in preference to 'optimal patent lives' because of the indeterminacy of the latter.

Finally, Telstra submits that the Commission should recommend that a review process apply to services already declared that are transitioned into a revised regime. Grand-fathered service declarations should also meet a revoke or retain test after a prescribed time threshold. The current revocation and exemption mechanisms have proved ineffectual and do not offer the type of protection from redundant declarations that sunset clauses offer. The LCS exemption, for example, has been under consideration for

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21 Draft Report, page 8.31.

a year, with the ACCC not yet having decided whether to grant an exemption. The highly public nature of the inquiry has merely served to extend the duration of the inquiry. A period of one year for reaching a decision is an unsatisfactory period of delay.

5.3 Appeal of declaration decisions

Telstra is concerned that the Commission has considered it inappropriate to extend the scope for appeals to the Australian Competition Tribunal ("ACT"). Telstra submits that the Commission should view the extension of merits appeal rights on decisions to declare a service or not to revoke a declaration as an effective constraint on regulatory creep. The ACT (including its predecessor, the Trade Practices Tribunal) has previously acted as a significant constraint on the discretion of the ACCC (and the former TPC) in the context of authorisations of conduct under Part IV. In the context of Part IIIA, the recent Duke decision suggests the ACT also operates as an effective body of review for declaration decisions of the National Competition Council ("NCC").

Telstra acknowledges that such an extension of merits appeal rights will, in all likelihood, slow the declaration process in the short term. More importantly, though, it will help ensure the integrity of the decisions and minimise the scope for regulatory over-reach. There is an important trade-off between speed and accuracy of regulatory decisions. Any benefits to the industry from avoiding a six- to twelve-month merits review process are likely to be substantially outweighed by the costs to society of not ensuring that the declaration power is constrained to those services that Parliament (and economic analysis) would suggest are most applicable for regulatory intervention.

Moreover, concerns about delay can be addressed in a more efficient (and equitable) manner than by removing an access provider's rights to appeal against a regulator's decision to bring a service within its purview of control.

5.4 Declaration of services by NCC

Similarly, Telstra is concerned that the Commission has considered it inappropriate to recommend the removal of the ACCC from the declaration process. Under Part IIIA, the responsibility for declaration and setting of access terms and conditions (determinations) is separated between the NCC and the ACCC.

Telstra submits that this division correctly recognises the need to distinguish between the policy decision (whether to regulate or not) and the regulatory process (on what terms and conditions should access be provided). This distinction has been removed in Part XIC with little or no justification having been provided for such a radical step.

One of the direct consequences of handing the powers of declaration to the ACCC has been regulatory creep. Under Part IIIA, the NCC has little incentive in terms of extending its own regulatory powers to declare a service. Under Part XIC, on the other hand, the ACCC has the ability – if so-minded – to extend its own powers in terms of the determination process by declaring whatever eligible service it believes should come within the purview of Part XIC. The ACCC can effectively decide what it wants the market structure to look like and then implement this by controlling both declaration and determination.

Telstra submits that the continued combination of judge and jury in this manner is unacceptable and the Commission should recommend that, consistent with the provisions in Part IIIA, responsibility for declaration of service under Part XIC should lie with the NCC.

5.5 Access holidays

5.5.1 Commission's request for information

In the Draft Report, "the Commission considers that there are grounds for modifying Part XIC to allow the ACCC to grant immunity from subsequent declaration to new telecommunications investments that would not occur if there was a threat of declaration (an access holiday). However, the Commission seeks feedback on how such an access holiday could be implemented, and particularly:

(a) the appropriate length of any access holiday;

(b) how to distinguish investments that are marginal from those that would still occur if they were declared; and

(c) any other guidelines that would simplify the implementation of access holidays."[22]

5.5.2 Telstra's position

Telstra welcomes the Commission's deliberations on reducing the risks associated with declaration and the negative impact this can have on the incentives for efficient

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22 Draft Report, page 8.27.

investment. However, Telstra is not convinced that the grant of an access holiday – which is taken to mean temporary relief from access regulation of new marginal investments – is the optimal mechanism for ameliorating the problems with the current arrangements. Instead Telstra submits that the Commission should recommend the introduction of safe harbours as an integral part of the Part XIC declaration process (see section 3 above).

Telstra has the following concerns with access holidays as proposed by the Commission:

(a) if an access holiday can be justified for a particular service or facility, then serious questions need to be raised about why the service or facility in question was eligible for declaration in the first place. This is particularly the case given that the Commission appears to be focusing its proposal narrowly on marginal greenfield investments;

(a) the narrow focus of access holidays on marginal greenfield investments also means that it will have limited impact in broader economic terms as the vast bulk of investments in regulated assets relate to the maintenance, upgrading and augmentation of existing facilities;

(b) there will also be significant administrative issues involved in determining what is a new investment and what simply represents an extension or upgrade of the network. Evidence from the airport procedure on necessary new investments indicates how regulatory intervention can distort decisions as between greenfields and expansion / renewal;

(c) in many cases an access holiday is of limited importance in the early stages of the asset's life (which is generally when the holiday is proposed to apply) when total revenues often fall below costs – although declaration could potentially increase the losses during this period; and

(d) regulatory access holidays could be used as a mechanism for avoiding broader reform necessary to ameliorate the negative impact that current regulatory practice has on incentives for efficient investment.

6. Part XIC: Terms and conditions of access

The Commission makes a number of very valuable recommendations in relation to how terms and conditions of access should be determined under Part XIC. Telstra will respond in detail to the Commission's recommendations and request for further information on these issues in a later submission. In this submission, Telstra offers its initial support for the thrust of the Commission's recommendations on pricing principles and notes some procedural changes that could potentially offer greater certainty to the access pricing process.

6.1 Commission's recommendation and analysis

The Commission recommends that the following principles be legislated for telecommunications, namely that access prices should:

(a) generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved;

(b) not be so far above costs as to detract significantly from efficient use of services and investment in related markets;

(c) encourage multi-part tariffs and allow price discrimination when it aids efficiency; and

(d) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher.[23]

The Commission reasons that:

(a) the *level* of access prices, while important, is only one of many criteria by which to judge a given approach to access pricing;

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[23] Draft Recommendation 10.1 (Draft Report, pages 10.23-4).

(b) the *structure* of access pricing is also likely to be an important determinant of efficiency;

(c) access pricing approaches will often involve a trade-off between complex designs (having demanding informational and administrative requirements) and more simple approaches; and

(d) enunciating some principles for access pricing may reduce uncertainty and regulatory error, as well as providing a clear framework for the future evaluation of the telecommunications access regime.[24]

6.2 Telstra's response

Telstra agrees with the Commission's recommendation that a clear set of appropriate pricing principles set down in legislation is likely to reduce uncertainty and assist regulators in establishing terms and conditions. Telstra therefore supports the recommendation that pricing principles be included in the TPA.

Telstra also welcomes the clear statement by the Commission that the costs of setting excessively low access prices are likely to be more insidious and have a more detrimental impact on economic welfare than the undoubted costs associated with setting access prices excessively high. This is a very important corrective to the current public debate which is dominated by an obsession with the short term benefits of lowering access prices and very little thought given to the longer term impacts of such prices on the incentives for efficient investment in essential infrastructure. It is critical that legislative pricing principles provide regulators with guidance on these relative costs.

Telstra is still examining the Commission's specific proposals regarding pricing principles, assessing the implications of the proposals and the extent to which they will act as an effective constraint on regulatory decisions. In general terms, however, Telstra welcomes:

(a) the Commission's attempt to set a revenue floor (the efficient long run costs) and ceiling (revenue not so far above costs as to detract significantly from efficient use). The current regime fails to provide this flexibility for commercial negotiations;

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24 Refer the summary discussion at page 10.23 of the Draft Report, and the preceding text.

(b) the explicit recognition that the costs of providing an access service include a return on investment commensurate with the risks involved;

(c) the explicit support for multi-part tariffs and efficient price discrimination; and

(d) the recognition that internal operations can receive favorable terms and conditions if the cost of providing access to those operations is lower.

There are, however, additional criteria that could usefully be included in legislation to help ensure regulators determine access terms and conditions that maintain incentives for efficient investment and for continued improvements in productivity. Telstra is currently drafting a list of such principles that the Commission could consider. At a minimum such a list would include requirements that:

(a) Regulators should be required to respect the principle of financial capital maintenance – that is, owners of regulated[25] assets should be allowed to recoup the capital invested in such assets over the lifetime of the investment where such investments are considered prudent at the time they were made;

(b) Regulators should be required to incorporate into regulated access prices the impact of regulatory risk;

(c) Regulators should be required to fully reflect service obligations and community expectations about service levels in regulated access prices;

(d) Regulators should be required to include strong incentives for producers to achieve productivity improvements; and

(e) Regulators should be required to ensure a fair sharing between producers and consumers of the gains from productivity improvements and technological change.

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25 Financial capital maintenance is only a policy issue in respect of regulated assets because the owners of these assets face asymmetric risks that arise from the fact that regulation truncates their ability to earn economic profits in good times that offset any losses made during the bad times. For example, unregulated firms can accept lower revenues during the early stages of a new service because they can expect to enjoy higher revenues as the service matures. Regulated firms, on the other hand, often tend to face annual limits on their revenues and hence are unable to offset earlier losses and hence are unable to maintain their capital investments.

Telstra undertakes to provide the Commission with more detail on these proposals in further submissions.

7. Pay television

7.1 Commission's request for information

The Commission has sought feedback on the following issues:

(a) the degree of, and motives for, exclusive contracting of pay television ("pay TV");[26]

(b) the effects of pay TV content foreclosure on different markets and the nature and timing of any efficiency costs;[27]

(c) the extent to which arrangements for the distribution of pay TV signals to regional operators are a problem, how important they are, and the impact that they may have on effective access to content for regional pay TV operators;[28] and

(d) the desirability of action to promote the availability of pay TV content, options for such and proposals for implementation.[29]

7.2 Telstra's response

7.2.1 Exclusivity arrangements

A key driver of market success in pay TV is the provision of content having sufficient appeal to attract, and retain, subscribers. In markets dependent upon content, this is uncontroversial, but critical.

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26 Draft Report, page 16.15.

27 Draft Report, page 16.17.

28 Draft Report, page 16.18.

29 Draft Report, page 16.32.

Similarly uncontroversial is that the normal commercial practice in such markets is to seek to secure content through, in many instances, exclusivity arrangements. These are an historically-observable and widely-spread phenomenon of content-driven markets due to the need to secure adequate numbers of subscribers in order to make economic the costs of the content which attracts those subscribers in the first instance and retains them. Without a level of exclusivity arrangements, network viability can be threatened.

The existence of such exclusivity arrangements does not, of itself, establish either an anti-competitive purpose or effect. Indeed, it can be said that the securing of particular content with subscriber appeal through the mechanism of exclusivity arrangements produces positive effects on competition, in the sense of driving platform competition.

7.2.2 Further industry-specific regulation of broadband delivery infrastructure

Telstra submits that there are no sound economic or policy reasons to warrant the application of any further industry specific regulation of broadband delivery infrastructure under the machinery in the Trade Practices Act.

To begin with, there is no evidence to suggest that there are any major problems with regional broadband delivery infrastructure that need to be addressed by additional access regulation. The market for the supply of broadband delivery services is increasingly competitive. In addition to the rollout of ADSL there is already substantial satellite-based and some wireline competition in place. If the current regulatory impediments to investment (see section 7.2.3. below) are removed there is substantial scope for increased investment in broadband infrastructure in regional areas. Even where the scope for competitive supply of broadband infrastructure is limited the substantial competitive constraints from narrowband technologies such as free-to-air broadcasting drastically limit the need for regulatory intervention.

Moreover, Telstra submits that any attempt to regulate markets in which broadband carriage services are supplied is likely to result in substantial regulatory distortions and impose significant costs onto society. These are very new technologies where the market is only just developing. Seeking to impose regulatory solutions on such nascent services is a process fraught with risks as no one – least of all regulators – is yet sure how demand and supply patterns will develop, particularly in regional Australia.

7.2.3 The appropriate response to the development of regional pay TV competition

In Telstra's view, the development of pay TV competition in parts of regional Australia is constrained, not by exclusivity arrangements, but by the regulatory constraints that exist and which deter efficient investment in alternative delivery platforms.

Telstra submits that, for an answer to the issue of the development of regional pay TV, the Commission should look to the various regulatory factors that currently distort investment in rural and regional Australia. There are at least four aspects of the current PSTN regulatory regime that directly impact on the incentives for investing in broadband communications infrastructure in rural and regional Australia. These include:

(a) the process of declaring access to and pricing services under Part XIC;

(b) the system of price controls that limit Telstra's ability to re-balance prices under subsections 20-24 of the Telstra Corporation Act 1991 (Cth) and Part 9 of the Telecommunications (Consumer Protection and Service Standards) Act 1999 (Cth); and

(c) the regime for funding the universal service obligations that Telstra is required to provide, as detailed in Part 2 of the Telecommunications (Consumer Protection and Service Standards) Act 1999 (Cth) and the Telecommunications Laws Amendment (Universal Service Cap) Act 1999 (Cth).

As Telstra has detailed at length in its submissions to the Commission, a combination of regulatory over-reach and a tendency to significantly under-price access to regulated services has substantially undermined the incentives for carriers to invest in new infrastructure, particularly in high cost areas such as rural and regional Australia.

The Australian system of price controls keeps PSTN access charges (rentals) artificially low and consequently inflates usage charges, including charges for bandwidth. Telstra submits that this reduces the incentives for investment in infrastructure in rural and regional areas. The effect on investment, notably in upgrading the CAN, arises from the fact that CAN costs are largely usage-independent; by making the recovery of these costs dependent on usage, the price controls increase investment risk. At the same time, by taxing usage, the controls discourage the development of new, usage-intensive, applications.

The detrimental impact of price controls on investment in rural infrastructure is exacerbated by the failure to ensure adequate funding for the provision of services in remote and rural Australia. Under the current USO funding regime, the universal service provider bears the overwhelming share of the costs of supplying access in rural areas at regulated prices. As a consequence of the failure to adequately fund the USO the incentives for the universal service provider to upgrade the rural and remote access network are further undermined. All universal service providers, including Telstra, require a commercial return before committing the investment necessary to provide the required services. Without certainty of commercial returns, universal service providers operating in a competitive market will either not make the investments required, or ultimately demand a higher risk premium than those investments would otherwise

require. In the longer term, this will reduce investment levels in rural and regional Australia.

Telstra submits that the Commission should recommend that these constraints on investment in broadband in rural and regional Australia be addressed expeditiously through the various regulatory review processes currently underway. It is less regulation, rather than more regulation, that is likely to provide the most efficient response to rural and regional concerns about access to broadband infrastructure and the services such as pay TV that are available over such infrastructure.