Telecommunications Inquiry
Productivity Commission
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Dear Sir

Supplementary Submission by Institute of Public Affairs

We attach herewith a supplementary submission to the Review of Telecommunications Specific Competition Policy.

Yours sincerely

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PRODUCTIVITY COMMISSION REVIEW OF TELECOMMUNICATIONS SPECIFIC COMPETITION REGULATION

SUPPLEMENTARY SUBMISSION BY THE INSTITUTE OF PUBLIC AFFAIRS

Introduction

There had and have to be rules to ensure access to certain essential telecommunications facilities in parallel with the deregulation of the industry in Australia.

The deregulation has been a stunning success so far and the occurrence of this minor miracle in other developed economies should not blind us to that. Moreover, the revolution is continuing. The number and diversity of enterprises and products is multiplying and the result is more competition in all markets. The prospects are good.

How we regulate the Australian telecommunications industry now will determine its future shape. Competition regulation in this sector is matched in importance only by regulation of the radiocommunications spectrum. Competition regulation should aim to break down the remaining monopoly structures. In this, it will be powerfully aided by the convergence of transmission technologies which is taking place independently.

The strong growth in productivity in Australia in the last decade owes something to deregulation and improved competition (see "Microeconomic Reforms and Australian Productivity" – Productivity Commission Research Paper – November 1999). The OECD has given Australia high marks for this, basing much of its judgement on the work done by the Commission ("A New Economy" – OECD – Paris - 2000). Telecommunications is no exception although it is accepted that there was a degree of catch up involved.

While we know that there have been benefits from deregulation of telecommunications and the associated increase in competition, we do not know whether the results have been optimal. Nor do we know with certainty whether they will be improved or made worse by the application of existing policy in the period ahead. The interaction of competition, planning and technology policies makes the equation even more than usually unstable.

The challenge now is to refashion regulation to encourage further gains without building a system that is so intrusive that it amounts to command and control. There is a risk that the eagerness to reallocate market shares in our local market will lead to regulation that is inward- looking and not in our long term interests.

Policy Constraints

The reform of competition regulation is heavily constrained by policies which impact on the operations and finances of carriers and carriage service providers, particularly Telstra :

- Price capped local calls without time limit

- Universal service obligations
- Any to any connectivity
- Limitations on the use of the radiocommunications spectrum
- Government control of Telstra
- No structural reform of Telstra

Reform of competition regulation in this sector is well into the realm of the second best for as long as these constraints persist. The net financial and economic costs they impose are subject to very wide disagreement although it is agreed that they are substantial. Through their direct effects on the operators' costs and prices, they also constrain the volume and direction of new investment.

There is a very strong case for relaxing some of these policies to reduce the distortions to private decision they induce and to transfer social provision directly to government. For example, there is no reason why the universal service obligations could not be better costed and charged directly to the Commonwealth Budget.

The Role of the ACCC

The telecommunications specific competition regulation confers great powers on the ACCC. It can, inter alia :

- endorse or make the industry codes that facilitate access
- accept or reject undertakings (generally the latter) relating to the charges and terms and conditions for access
- declare services under the Act and establish principles for pricing and other terms and conditions of access
- arbitrate disputes over the terms and conditions for declared services and also access to information and facilities
- direct the conduct of disputes
- direct the ACA on matters such as number portability and technical standards

There are numerous proposals (including from the ACCC) to extend these powers significantly, including :

- to direct relevant firms to give detailed access undertakings which may be drafted by the ACCC
- to vary declared services without the inconvenience of a public inquiry
- to remove certain review powers of the Australian Competition Tribunal

The ACCC is also looking forward to the stage where it will not only regulate physical bottlenecks but also content bottlenecks. There is also the potential for greater ACCC involvement in the market for internet services.

It is worth recalling the stated aim of the ACCC, which is to "facilitate rather than prescriptively determine the operation of competitive markets".

What has actually happened is that the ACCC now exercises far greater market power in the telecommunications market than any other player and it does so with legislative backing and without any penalty for its abuse.

If there was a need five years ago for the current highly intrusive level of regulation then the operation of the regulation should have led by now to a point where some of it could be dismantled. The call for further regulation now is disturbing and suggests that the existing structure may be, perversely, generating its own amplification. The structure now needs reform to ensure its automatic demise in a reasonable timeframe.

The Competition Criterion

The working criterion for ACCC intervention within its legislated powers is the "long term interests of the end users". This gives first priority to the consumer. The drawback is that this tends to focus attention on the short term impacts on prices and the quality of services away from the longer term needs to invest in change. This will always be the case for an agency such as the ACCC with a strong consumer mandate and a high political and media profile. What we have is not a competition criterion but a consumer criterion, which can only be a partial guide to optimal policy.

This is exacerbated by reliance on best practice pricing models. They leave the margin for investment in the hands of the regulator who will have neither the detailed knowledge of the investment equation nor the responsibility for the outcome and will be under constant pressure to mortgage the future for the present. Also, the best practice firm tends to be measured by the level of pricing for specified services which may tell us little about its prospects for long term health.

The regulator is likely to have little sympathy for the phenomenon of creative destruction both within and between firms as they strive to innovate and inevitably "waste" capital in the process. Innovation often proceeds by way of a series of trials, a proportion of which will fail. With best practice hindsight, these will simply be regarded as mistakes. Such fruitful "mistakes" are not easily accommodated in pricing that is based on an international best practice model. They require a model that would allow for temporary market imperfections which accommodate a degree of experimentation.

This process, which is a form of research and development, requires a pool of capital and a willingness to spend it without too much detailed direction. This is difficult to model and virtually impossible to implement within the time frames of the regulatory process. Yet this is just the sort of investment we need to participate fully in this industry while it is in the growth phase. The alternative is to be relegated to colonial status, entirely reliant on overseas technology.

All this has considerable relevance for our technological future. Telstra is perhaps the only major corporation in Australia with any incentive to go beyond the mere provision of telecommunications services to research and development in Australia. Prices that allow for this role will not in themselves guarantee the fruitful use of resources but best practice models are likely to result in prices that have little margin to even make that opportunity available.

Dominance

The market power of Telstra in the telecommunications market is at the heart of competition policy. There is no doubt that Telstra retains considerable market power (particularly in the customer access network) and that the watchdog role of the ACCC will still be required in the future.

Nevertheless, the competitive landscape has changed dramatically in the last decade and the complete dominance previously exercised by Telstra has been significantly eroded by strong new competitors. This erosion will continue. It should be facilitated by competition policy.

However, what seems to be happening is that the new entrants are happy to see parts of the status quo maintained. This is a de facto structural separation of Telstra brought about by the ACCC managing key aspects of the local loop.

This clearly has implications for the value of those assets involved in the local loop and for the Telstra share price. The new entrants and the ACCC now propose that this structural separation be enhanced and entrenched by additional powers for the ACCC.

The result would be that Telstra's formal dominance would be perpetuated (together with the justification for the regulatory regime) but crucial operational and financial decisions for Telstra would be made by the ACCC.

The new entrants (who are often not really new any more) are then able to "cherry pick" the profitable long distance and high density local business using the administered physical access and access price as a firm base. There is little incentive for them to invest in independent capacity and new technologies to enable them to compete with Telstra's local system.

This policy encourages cannibalism rather than creation.

It is competition of a kind but it does not appear to embody any dynamic that will lead to a fully fledged market with well developed facilities based competition. Nor, as noted, will the regulation itself stand still because the defects of the regime have and will lead to pressure for more detailed intervention.

We can only hope that the sheer weight of innovation from overseas will force change in these heavily regulated areas, perhaps through convergence and use of over the air channels. Otherwise there is the risk of a persistent cosy "live and let live" arrangement, supervised by the ACCC, with high levels of churn based on relatively small product differentiations.

The Local Loop and Network Effects

The new telecommunications competitors are not duplicating the local telephone loop in any significant way. Nor, apparently do they intend to do so. Our competition policy has signally failed to introduce meaningful facilities based competition in this most important area.

The reason appears to be that the access terms provided to new entrants by the ACCC as compared with the costs of investing in new networks make new investment unprofitable.

The public interest may not be served by expensive duplication of the local loop - especially as the capacity of the existing loop is being upgraded and convergence may offer alternatives. In that case we should ensure that this network, put in place at great expense to the Australian people over decades, should earn a return from new entrants closer to what it would cost them to provide their own facilities. It might also more effectively test the proposition that duplication is uneconomic.

This would leave the monopoly characteristics in place for a while and a continued (but diminishing) need for an access regime.

Much has been said about the leverage granted to Telstra by network effects and it has been asserted that this leverage will increase with the upgrading of the local network. In theory, an effective access regime ought to give new entrants the same possibilities on the network as the incumbent, taking as given that they will in any case have to undertake ancillary investment to enter the market at all. The incumbent will have the normal first mover advantage but this should not confer permanent leverage if the new entrants use their advantages of more recent technology, greater flexibility, fewer CSO obligations and no government ownership.

Short of imposing bans upon normal competitive behaviour by Telstra, which would be difficult to define and administer, the only course is to rely on the enterprise of the new entrants. Many of them are backed by large overseas corporations and could be expected to have the knowledge and resources to compete in a relatively small market such as Australia. In a sense they have their own critical mass. And the history of recent years does seem to support the conclusion that they can survive and prosper.

Smaller new entrants would face greater challenges (as is always the case) and would have to rely on the competition watchdog to assist them when they encounter unfair practices. Their case is no different from start up in other sectors where large incumbents deploy the advantages of large networks.

Of course, structural separation of Telstra might help here.

Part XIB

Part XIB of the Act was intended to be a transition measure. It contains elements that were enacted to meet the special needs of the telecommunications market in its then undeveloped state several years ago. Some of these elements, such as the reversal of the evidentiary burden, the escalation of penalties and the “likely effects” test, if applied to individuals, would give rise to grave public disquiet as unfair and as being an excessive assumption of state power. They should not be maintained beyond the point of absolute necessity.

Only two competition notices have been issued under Part XIB and these were eventually revoked after negotiation. It is not clear that the settlement could not have taken place under the more general competition rules.

The ACCC has proposed that its power under XIB now be augmented to allow it to direct persons to do what it thinks would conform to competitive behaviour – conduct that would be expected (by the ACCC) in a competitive market. An example might be a direction to enhance or replace technology. This would considerably extend the power that the ACCC currently has to forbid certain conduct and its powers in the setting of standards.

This would be a quite breathtaking increase in the power of a non- expert government agency to direct a central component of our new economy. The ACCC would become even more the controller of operations and investment planning for this sector. We do not think these proposals should be countenanced. Indeed, as we argued in our earlier submission to the Commission, we believe it is time to repeal Part XIB not to entrench it.

Part XIC

It was reported on 28 August that the ACCC had demanded detailed weekly reports from Telstra on how it would open up its network to its competitors as it rolls out ADSL. The Chairman of the ACCC was also reported as saying that he would be monitoring those competitors to ensure that they improved their performance in lodging their orders for access.

This perfectly illustrates the tendency of prescriptive economic regulation to lead to the aggrandisement of powers by the agency involved, all in the name of the public interest. Here we have an official agency requiring a level of reporting that the executive of most firms would not consider necessary for efficient management – indeed it might be considered conducive to bad management both in the use of resources (which are costly) and the focus on the insistent focus on the concerns of a single overbearing manager. Why would reporting quarterly not suffice?

Even more strange is the jollying along of competitors to do what it is either in their own interest to do or, if not in their own interest, is unlikely to be sound either as a private or a public proposition.

Moreover, without being chauvinistic about this, what we have is an Australian government agency effectively forcing the partial appropriation at administered prices of a vital Australian owned and built asset by a group of large, generally foreign-owned enterprises that will invest no more than is necessary to their own ends. Those ends may well be legitimate but we can safely leave them to be pursued without official pressure.

The question is whether the current level of highly detailed and prescriptive government intervention in Part XIC will give the optimum outcome in the years ahead. Some are proposing even more interference. On the other hand, the OECD has stressed the principle of carriers managing their own tariff structures. We have suggested that XIC could be repealed.

The record in some respects supports the current regime. Both the OECD and the IMF (reported on 20 September) have commented favourably on the take up of

telecommunications technology in Australia in the past decade. The opening of the market to competition has undoubtedly contributed to this result and the role of the ACCC has been vital.

However as competition has improved there has been no indication that the watchdog is ready to hand over to the market. On the contrary, the watchdog has turned into a sheepdog and clearly has ambitions to be the shepherd for this sector.

There is a risk that we are sliding towards an administered industry policy or state planning for telecommunications. When the ACCC asserts that its pricing decisions take account of the long term investment needs of the industry it should give pause to policy makers. Not only is the ACCC not equipped to undertake investment planning but it has an institutional bias towards lower prices and short term consumer gain and a propensity to allow no margin for error. Perhaps more telling, the ACCC will bear no responsibility for the success or otherwise of its investment planning activities.

It is time for the ACCC to step back a little from its engagement with this industry, exciting though it is. It is time to test the counterfactual. There is no evidence to suggest that reliance on Part IIIA of the Act and the tests it contains would not lead to lower prices, better services and more choice. There is now considerable weight to competition.

The ACCC has noted that it was never intended that it become the price setter for the industry but the drafting of the existing regulation ensures that it does. The structure of XIC leads inexorably to ACCC arbitration in almost every case. We do not have a negotiate/arbitrate model, we have an arbitrate model.

Reversion to IIIA would oblige the ACCC to take a step back and encourage the industry to seek more vigorously for commercial agreements and undertakings. The loss of the more detailed powers for the ACCC in terms of declarations and standard access obligations can be countenanced.

At the same time the Government should require the development of a sequential program of deregulation of services, starting with the easiest to enter. This would oblige all parties to contemplate the end of administered access and pricing and encourage the development of effective, rather than protected, competition.

The option of trying to speed up the Part XIC processes by enhancing the power of the ACCC will only confer greater market power on the ACCC without any real prospect of quicker decisions. More and more detailed powers will slow progress and create uncertainty in an industry whose lifeblood is rapid response to change.

Part XIC should be repealed.

Conclusion

The question is – where do we go from here? Or more precisely – which direction do we go and how far?

There is evidence that competition regulation has provided substantial benefits in the transition to a more competitive telecommunications market. This does not imply that more of the same will produce the same benefits. Competition regulation is not per se beneficial.

There are many proposals before the Commission to extend the level of government intervention and remove review mechanisms. These proposals are generally justified by the need to make the regulation more effective. Past experience suggests the inevitability of this trend and the entrenched nature of the multitude of special interests it creates and protects. The unavoidably lengthy processes involved are extremely inefficient means of economic decision making. We believe the effects of the regulation are already anti-competitive in some respects and will become more so.

We believe that it is time to reverse this trend and return the industry to the more general protection of competition law which was strengthened only a few years ago. If we do not take this course now the opportunity will be lost and the regulation will be with us indefinitely.

The telecommunications industry will restructure repeatedly in the next decade as technological advance and convergence take place. There is an opportunity for Australia not only to let that happen to us as part of a world wide development but to participate more actively . It is unlikely that we will attract or generate the interest of those at the cutting edge or the sort of investment and innovation required if we retain the existing, detailed, inward looking regulatory set.

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