Telstra

Telstra Corporation Limited

Productivity Commission's
Draft Report on
Telecommunications Competition Regulation

Second Further Submission

September 2001

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1. Overview

Telstra Corporation Limited ("Telstra") notes that the Productivity Commission (the "Commission") has recently received some further submissions to its *Review of Telecommunications-specific Competition Regulation* (the "Review"), in particular submissions dealing with the repeal of Part XIB of the Trade Practices Act 1974 (Cth) (the "Act").

In Telstra's view, the Commission, in considering these Submissions, needs to pay particular regard to the actual experience under Part XIB. The issues that experience raises, have been put in sharp relief by recent developments, and most notably by the issuing, by the ACCC, of a Part A Competition Notice to Telstra in respect to certain aspects of the supply of ADSL services.

Given that the matters at issue in the Notice may be the subject of legal proceedings, Telstra is not in a position to provide a detailed discussion of the allegations the ACCC has made. However, in this Submission, Telstra sets out some considerations that may assist the Commission and then draws connections to views it has raised in earlier Submissions and that have also been raised by other parties.

2. ADSL case study

On 7th September 2001, the ACCC issued a Part A Competition Notice against Telstra. This followed correspondence from the ACCC in late August and early September 2001, in which the ACCC wrote to Telstra saying that ACCC staff had reached the conclusion that Telstra's conduct in the supply of ADSL services breached the Competition Rule and that the ACCC would proceed expeditiously to decide whether to issue a Competition Notice.

In Telstra's view, the current ADSL proceedings exemplify, in an especially blatant way, the serious risks and high costs associated with the provisions of Part XIB of the Act. More specifically, those provisions allow, and in Telstra's view positively encourage, the ACCC to use the threat of *in terrorem* penalties to extract, or seek to extract, concessions advantaging favoured players in the market, with little or no regard for the costs this imposes on Telstra, for competition as such and for long term efficiency.

In its Competition Notice, the ACCC has alleged that Telstra has acted in breach of the Competition Rule and acted anti-competitively by:

- **not making available a layer 2 ADSL service[1] to parties wishing to obtain such a service on wholesale terms from Telstra (the "service architecture" conduct); and**

- **pricing the layer 3 wholesale ADSL service[2] (known as "FlexStream") in a manner which, given current retail prices, allows competitors buying the wholesale ADSL service "only a small positive margin or a negative margin" (the "pricing" conduct).**

The ACCC alleges that the conduct, individually and together, is a taking advantage of a substantial degree of market power with the effect, or likely effect of substantially lessening competition in the "residential and small business broadband retail market".

Whilst Telstra does not seek to argue its case in this submission, there are some aspects of the ACCC's investigation and "analysis" which merit specific comment.

To begin with, it is important to note at the outset that well prior to the Notice being issued, Telstra had announced its intention to develop and implement a layer 2 wholesale service and to introduce line sharing, and, that the ACCC was well aware of this intention. Moreover, an aggressive timetable for the service's development and implementation had been announced. This is consistent with Telstra's overall strategy, which is to promote broadband penetration, including as a means of reducing the pressure data traffic currently places on the PSTN.

The ACCC's claims with respect to service architecture therefore amount to a demand that Telstra vary the architecture for the deployment of a layer 2 wholesale capability.

Telstra finds it difficult to understand the basis on which an administrative agency, with no substantial technical expertise, can seek or threaten draconian penalties on a highly technical matter without disclosing any cost-benefit analysis of the implications of altering the service architecture. To the best of Telstra's knowledge, the ACCC rests its claim on the grounds that, in its view, such services exist in the United States; the relevance of this claim to the efficient architecture in Australia has never been established.

Telstra sees equally little foundation for the ACCC's allegations with respect to pricing. These allegations centre on a claim that Telstra has engaged in a vertical price squeeze,

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[1] **A "layer 2 ADSL service" is one which uses a layer 2 protocol such as ATM over ADSL. These layers refer to the layers as defined in the Open Systems Interconnect reference model developed by the International Organisation for Standardisation (ISO).**

[2] **A "layer 3 wholesale ADSL service" is one which uses a layer 3 protocol such as IP over ADSL. These layers refer to the layers as defined in the Open Systems Interconnect reference model developed by the International Organisation for Standardisation (ISO).**

based on an assessment of the relativities between its retail prices for ADSL and its prices for the wholesale FlexStream service. It is said by the ACCC that these relativities are such that they allow competitors buying the wholesale ADSL service "only a small positive margin or a negative margin".

It is hardly surprising for a retail product that is subject to learning and scale economies in the cost structure of its supply to be priced keenly at retail. Service providers also bear the risks of inducing customers onto this product and achieving returns to scale over time However, the ACCC chooses to view the world on the basis that Telstra is under an obligation to supply the wholesale service at charges such that, for any given Telstra retail prices, wholesale customers can "compete with Telstra's retail services without incurring significant financial losses". Such an approach is, in Telstra's view, completely inconsistent with any concept of competitive neutrality, much less economic efficiency. It is simply an attempt to force Telstra to under-write its competitors' losses, without any prospect, means or security of recoupment.

3. Lessons from the ADSL Case Study

Telstra concurs strongly with the view expressed by the High Court in its recent *Melway* decision, when it said that:

> **"There is some force in the suggestion, that appealed to the Privy Council in Telecom Corporation of New Zealand v Clear Communications Ltd, that provisions such as s46 should, if such a construction is fairly open, be construed 'in such a way as to enable the monopolist, before he enters upon a line of conduct, to know with some certainty whether or not it lawful'."[3]**

The High Court then emphasised this point when it noted that it was crucial to any determination of whether or not a breach had occurred to consider the remedy that had been proposed, and assess the effect of that remedy. There had to be conduct, that could be specified to the party alleged to have engaged in the breach, that would not be in breach, and hence could lawfully be engaged in by the party.[4]

This basic principle has been entirely ignored by the ACCC in the ADSL proceedings. Rather, using the looseness that successive amendments have accentuated in the Part XIB provisions, the ACCC has failed to provide any guidance as to what conduct by Telstra would be lawful.

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[3] ***Melway* at paragraph 8.**

[4] ***Melway* at paragraph 60.**

The ACCC has not sought to specify an appropriate layer 2 ADSL service that would in its view be acceptable. Even more importantly, the ACCC has not been willing to clarify what meaning, if any, can be given to a requirement that wholesale customers be rendered able to "compete with Telstra's retail services without incurring significant financial losses". Which wholesale customers are at issue here? What cost levels ought to be used as a basis for assessing any losses they might incur? And how much of a margin must be allowed for the wholesale-retail relativity to be acceptable?

Far from addressing these important issues, the ACCC has chosen to leave them entirely open. The ACCC's position, set out in a letter of 3 September 2001, is that:

> **"With regard to the particular prices Telstra should charge, Telstra is in a far better position than the Commission to determine the particular prices necessary for Telstra to avoid breach of the Competition Rule."**

This begs the obvious question of how ACCC staff have purported to determine that Telstra's prices have indeed breached that rule. No less seriously, it completely abdicates the responsibility the ACCC has, consistent with the guidance of the High Court, to provide concrete indication of the conduct that is lawful.

Telstra believes that this would not be possible under the provisions of Part XIC, even with its current flaws. Thus, had the ACCC sought to declare a layer 2 wholesale service, it would have had to test that declaration decision against the statutory criteria, which have regard to technical feasibility. Some consideration would have had to be given to the effects, on consumers and competition, of administratively withdrawing scarce investment funds from other uses so as to meet the needs of those who have a special interest in the service in question.

Finally, it is apparent that under Part XIC, even in its present, unsatisfactory form, the ACCC could not hope to rely on the concept that Telstra's competitors should be insulated from losses as the basis for making a determination with respect to access prices.

4. Conclusions

The ACCC has recently put to the Commission a number of reasons which, in its view, justify the retention of industry-specific conduct regulation. Most of these do not merit specific comment. However, the facts in the case reviewed above, consistently with those of the other cases examined in previous Submissions put by Telstra, do throw further light on some of the justifications for industry-specific regulation the ACCC claims to identify.

More specifically, in its most recent submission, the ACCC writes:

> **"… The ACCC maintains that the very design of Part XIB, with a 3-stage process alleviates concern about potential error.**

> **First, the ACCC would need to err in a decision to issue a Part A competition notice following a 'reason to suspect'. Second, the ACCC would have to err if it issued a Part B notice. Third, if the case proceeds to litigation, the potential for error would lie with the judiciary. The ACCC's success rate in litigation has been more than 90%."[5]**

Additionally, the ACCC says that:

> **"The ACCC maintains that the lack of court action is by no means an indication of ineffectiveness of the provisions but one of sound and fair use of the provisions by the regulator."[6]**

In Telstra's view, the ACCC's statement notwithstanding, it is extraordinary that while (according to the ACCC) 15 complaints have reached the 'reason to believe' threshold, none has led to a successful prosecution. Underpinning this reality is the fact that the many stages involved in the Part XIB process have proven time and again to invite the ACCC to engage on what are no more than "fishing expeditions." From the ACCC's point of view, as well as from that of complainants, unleashing these processes is a low-cost option. However, very high costs are imposed on Telstra, as each stage in the process consumes substantial resources in preparing responses to material that is all too frequently as poorly thought out as that referred to in the ADSL case study.

Additionally, and perhaps even more importantly, the very high penalties threatened, can and are, used by the ACCC to elicit concessions that a more transparent and accountable process could never have secured. Given the inefficiencies these concessions entail, the social costs of the mechanism are, in Telstra's view, extremely high.

Overall, the ACCC is inconsistent in the way in which it presents its so-called evidence. On the one hand, it claims that one of the advantages of Part XIB is that it does not involve direct court action but administrative remedies. On the other hand, it cites the lack of court action in support of the success of an administrative approach. The argument is clearly circular. In addition, the fact that the ACCC has not taken many cases to court does not prove anything in terms of regulatory overreach, since it may not go to court unless it is convinced it can win; meanwhile it takes regulatory action to the "reason to suspect" stage which is very costly. In either case, the participants have incurred substantial costs (as described in Telstra's earlier submissions), even if the regulator has incurred very few. As for the long term interests of end-users, the ACCC cannot point to any case in which this has been promoted. Rather, Part XIB has always been, and remains, a mechanism for conferring rents on favoured market participants, at efficiency's long term expense.

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5 **ACCC Submission, page 14.**

6 **ACCC Submission, page 13.**