TELSTRA INQUIRY

Submission No. 35

THE INTERNET PROTOCOL CARRIER

Submission to the Structural Separation Of Telstra Inquiry House of Representatives Communications, IT and the Arts Committee

January 2002

1. Introduction

Comindico welcomes the opportunity make this contribution to the House of Representatives Communications Committee Inquiry into the structural separation of Telstra.

Comindico is a privately owned telecommunications company, created in 2000. The company has constructed a national telecommunications network capable of carrying voice and data traffic across a single network architecture. The Comindico network is exclusive based on IP (Internet Protocol) technology; a technology that is capable of carrying services such video, messaging, voice and video conferencing or any other form of digital data. I t is the only national 100 percent IP based network capable of carrying carrier grade voice services.

Comindico is a member of the Competitive Carrier Coalition and is one of the supporters of a separate submission to this inquiry prepared by ACIL Tasman.

Comindico would welcome the opportunity to appear before the committee to discuss in more detail the material contained in this submission or any issues or points of concern that the committee feels Comindico could assist with.

2. Comindico's responses to the Inquiry's terms of reference:

The terms of reference for this enquiry address the merit of a specific proposition to change the structure of Telstra's business operations within the wider context of the telecommunications sector in Australia.

It must be recognised that the particular structural proposition which is the subject of this inquiry is but one of many possible approaches to the structuring of Telstra's business operations within the context of policy approaches for the regulation of the telecommunications sector. The merits or otherwise of this particular proposition do not necessarily extend to other approaches which might have the objective or effect of structural changes within the sector.

It is evident that this proposition or alternative policy propositions affecting the structure of Telstra's operations arise from a background of concerns about the current structure and operations of the telecommunications sector in Australia. In other words, it is important to understand the problem the solution is designed to address. **To conclude that this particular proposition is not the best solution to that problem is not to conclude that the problems which may have given rise to this possible solution do not need to be addressed by other means.**

At the heart of this Inquiry is the question of whether the scope and structure of Telstra's business operations substantially affect or determine industry and market behaviour, investment, pricing and structures within Australia's telecommunications sector. It is argued that the tests applied by the ACCC in determining matters of market power and in applying merger and acquisition tests are relevant to assessing whether Telstra's firm structure has economic and social impacts which merit policy and regulatory examination.

This submission further argues that:

- As a result of policy decisions taken in 1990/91, Telstra dominates the communications market in Australia and effectively shapes the structure of the Australian market, with the effect that competitiveness has actually weakened rather than grown since full market liberalisation in 1997.

- Whilst communications markets are becoming more differentiated and specialised, Australian industry participation has consolidated and shrunk. Whilst many other telecommunications operators internationally have specialised, Telstra remains a "full services", vertically integrated operator. The policy parameters around the creation of Optus as a duopoly competitor over the period 1991 to 1997 ensured Optus had to mirror Telstra rather than being able to create an independent business model..

- Telstra's core network asset, the local access network, is an obsolescent, sunk investment. Globally and in Australia, infrastructure re-investment in this core national infrastructure is at historically low levels (recent investment has focused on mobile infrastructure, and overlay connectivity services). Next generation broadband infrastructure will require significant new infrastructure investment. **The key policy question is whether Telstra's incumbent control of the current infrastructure will prejudice optimal national and market outcomes with respect to patterns of new infrastructure investment and service delivery.**

- The break up of vertical integrated operations does not necessarily reduce shareholder value. Indeed, it may increase shareholder value - which is why some other telecommunications operators have spun off lines of business and specialised.

- **The underlying issues that give rise to the proposition before this Inquiry will not go away, and Comindico argues that new regulatory divestiture (anti-trust) powers are needed if the Australian telecommunications sector is to maximise its economic contribution and consumer benefit.**

3. Telstra's market dominance.

Telstra presently is in a position to control and determine sectoral outcomes and overall industry structure to a greater degree than in most advanced economies. This leads to systemic market distortions in the Australian telecommunications sector.

Telstra is the owner of bottleneck infrastructure and acts both a supplier of retail and wholesale services utilising these infrastructure. Regulation seeks to employ an array of purely behavioural remedies to force Telstra not to use this power to its advantage against direct competitors.Put simply, regulatory mechanisms to underpin competition in Australia rely almost exclusively on creating an obligation for one company (Telstra) to sell services it does not wish to sell.

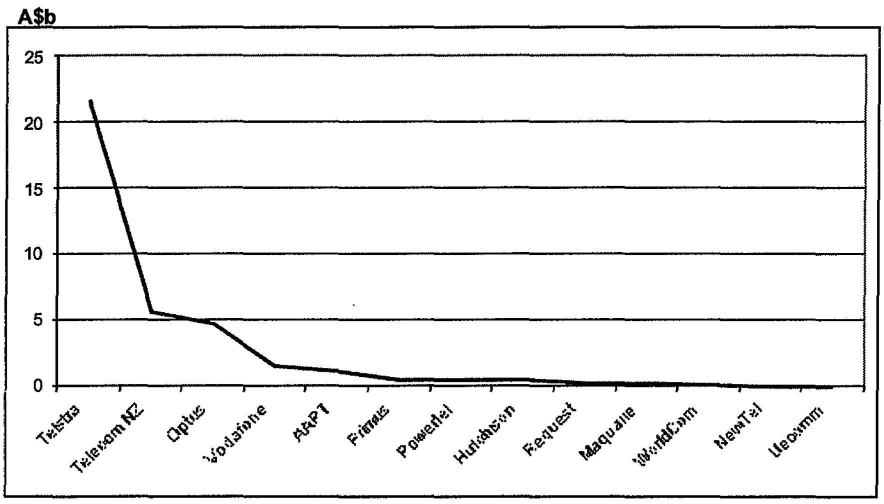
The scope and scale of Telstra's business operations create a degree of vertical integration and industry dominance that is close to being unparalleled within OECD member countries. The effect is to undermine competition policy and decade old measures to promote market liberalisation.

Telstra's market dominance is a function of three factors:

(i) Telstra is the largest service providers in each of the markets of fixed voice services, mobile communications, data services, the Internet, directories, and pay television and is the de facto monopoly supplier in most regional markets.
(ii) Telstra controls the basic network infrastructure on which other service providers rely.
(iii) Telstra's vertical integration as a "full services" operator that enables it to bundle service offerings and to leverage market strengths from one product market to another.

The following exhibit graphically highlights the extent to which Telstra dominates the Australian market.

AUSTRALASIAN TELECOMMUNICATIONS REVENUES, 2001



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It is estimated that Telstra captures 95% of sector profits (or more, if the full impact of new entrant losses is taken into account[1]).

It is important that this is kept in mind when assessing, for example, discussions regarding the merits of structural separation emanating from other OECD countries.

It should also be kept in mind that the industry structure in Australia did not arise by accident. Political and policy decisions made in 1991 deliberately created Telstra as a "national flagship" able to stand its ground in global markets. There is much talk of natural monopolies in relation to various elements of telecommunications, but it must be remembered in the context of such discussions that there is nothing "natural" about the manner in which Telstra's monopolistic power developed.

It is submitted that the scope and scale of Telstra's operations causes problems for industry structure and competitiveness, with adverse economic and social consequences, because:

- Corporate growth imperatives have made it difficult to deduce Telstra's definition of its core business as characterised by its constituent product, market and geographical segment activities. In defining itself as a "full services" carrier, the scope of Telstra's business has kept expanding, including by acquisition.

- Australia's underlying market characteristics embed Telstra as a de facto monopoly provider in regional Australia, limit competitive investment in new infrastructure, and restrict the scope for robust competition. These characteristics include:

  - the skewed population distribution across a large continent;
  - the relatively small population, with low growth;
  - Australia's distance from global capital and industry markets.

  For Australia, the tyranny of distance and density lives on.

- The history of industry evolution in Australia and the legacy of past sector regulatory policies have entrenched, not diminished, Telstra's strong market position. These include:

  - the political decision to create a national flagship "megacom" through the merging of Telecom Australia and OTC despite strong argument for the structural separation of public assets to ensure stronger competition;
  - mandating Telstra as national the "carrier of last resort" as the nominated Universal Service Provider, entrenching a regime of intra-sectoral cross subsidies;

[1] OECD, Communications Outlook, 2001, p.13

- Telstra's ability, by default, to capture the bulk of special sector funding programmes, including the Networking the Nation funding.

- Regulatory mechanisms deployed in other reference markets, notably the UK and US, have not been similarly deployed within the Australian market at the level of industry structure. In particular:
  - anti-trust powers in the US have played a significant role in shaping industry structure, and specifically the break up of AT&T in 1984 as the platform for competition policy;
  - cross-media regulation in the UK has played a significant role in shaping competitive access markets. British Telecom was specifically excluded from local Pay TV franchises, which resulted in the creation of local access competition.

In Australia the Trade Practices Act, and the telecommunications specific regulations, contain provisions for remedies against anti-competitive conduct. Legislation to strengthen the efficacy of these remedies has been recently introduced. The sector has also seen the use of merger and acquisition controls to prevent the strengthening of competition to Telstra. What is lacking in competition regulation is a complementary divestiture or anti-trust power to match the merger controls. **It is perverse that the merger and acquisitions tests can be applied to competitors when the application of the same tests on an anti-trust basis could conceivably lead to regulated divestitures or controls in the case of Telstra.**

Section 50(3) of the *Trade Practices Act 1974* provides for a number of factors to be considered by the ACCC in assessing whether a proposed acquisition would be likely to have the effect of substantially lessening competition. These “merger factors” are:-

- Actual and potential level of import competition in the market;
- Height of barriers to entry to the market;
- Level of concentration in the market;
- Degree of countervailing power in the market;
- Likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins;
- Extent to which substitutes are available, or likely to be available in the market;
- Dynamic characteristics of the market, including growth, innovation and product differentiation;
- Likelihood that the acquisition would result in the removal from the market of a vigorous and effective competitor; and
- Nature and extent of vertical integration in the market.

The United States District Court for the District of Columbia provides one of the most celebrated cases on the issue of competition or anti-trust laws in its action against Microsoft Corporation[2]. In making its assessment on whether Microsoft had engaged

[2] United States of America v Microsoft Corporation (Civil Action No.98-1232); State of New York v Microsoft Corporation (Civil Action No. 98-1233)

in anti-competitive behaviour and enjoyed monopoly powers, the Court applied *inter alia* the following factors: -

- Market share;
- Height and level of barrier to entry; and
- Viable alternative sources of supply.

Comindico continues to argue that structural issues within the telecommunications market justify the addition of divestiture powers to the Trade Practices Act.

3. Firm level consolidation versus market differentiation.

Until the 1980s telecommunications was a single product, homogenenous industry sector run by state-controlled utility monopolies. The processes of market liberalisation and de-regulation which reshaped the sector during the 1980s and 1990s were driven by underlying technology and market developments involving:

- the unbundling of network business operations into discrete markets
- the re-profiling of the telecommunications business mix non-voice revenues displacing voice in less than a decade. This is further indication of the profound business and technological changes of recent years that have occurred without fundamental revenue of structural policy issues in Australia
- changing relationships between carriage and content markets with the convergence of telecommunications and media markets.

In Australia, the incumbent has retained control of the sector with limited diversity of ownership and industry participation and has expanded into new content markets. Following the post 1990s collapse of the technology investment boom, industry participation has shrunk and diversity has diminished. It is noteworthy that not only has Telstra retained a dominant position in traditional product segments where it previously held monopoly incumbency, but Telstra has also been able to establish a dominant position in new product markets, such as the Internet and pay television.

In parallel to this market consolidation, the underlying technological rationale that has shaped past investment decisions has become increasingly irrelevant. Market specialisation, both in the vertical infrastructure and services mix, and geographically, has become more than ever possible by virtue of the emergence of software based technologies such as Internet Protocol.

4. Infrastructure control and investment

Telstra's core business strength is its control of the fixed line access network. New infrastructure investment by alternative operators has been primarily in long distance links, wireless facilities and spectrum, and network operating systems.

Telstra's installed local access network infrastructure is a sunk investment, fully depreciated and obsolescent. It will not support next generation broadband network functionality (beyond the limits of DSL, which is an interim solution for network upgrades with a finite half-life). **The critical issue is who will control the investment in next generation network infrastructure, and whether industry ownership and structure will influence the likely patterns of new infrastructure investment.**

In considering this issue relevant considerations include:

- the investment bias towards high density markets (and segmentation of markets by investment prospects). As argued below, a commercially oriented Telstra would not invest in low-density regional Australia as a priority.

- timing of infrastructure investment (control of timing of investment decisions). Dominant incumbents have both the power and the incentive to dictate and determine the timeframe of investment in innovation, and independent of any national interest.

- greenfields infrastructure rollout scenarios versus legacy distortions.

- infrastructure business models
  - different models in related markets - eg shared use in mobiles/wireless; international cables, satellites, and broadcast transmission networks.
  - cross subsidisation versus direct segment incentives (as in the US and Europe).

5. Shareholder value

While technology and global investor expectations have both been transformed over the past decade, Telstra has remained as much a victim of the regulatory and legislative straitjacket created in 1991 as the rest of the industry has been hostage to its market power.

The ability to segment telecommunications markets to much finer degrees through the deployment of recent emerged technologies has led to:

- RoI differentials across geographic markets
- Divestment (business function/rural networks)

It is noteworthy that, independently of regulatory divestitures, numerous major telecommunications have moved to spin off lines of business of business to create more focussed, agile corporate entities.

Comindico contends that the status quo does not maximise Telstra's shareholder value nor optimise sector output (leading to economic inefficiencies and social costs).

6. Remedies

As described above, the terms of reference to this inquiry describe one option for dealing with the increasingly problematical structural issues confronting the regulation of communications in Australia. A more complete description of the available options would include::

- **legislative remedies** or Government directives (via public ownership controls) i.e direct government intervention to force a restructuring along lines determined by the Parliament or Executive.

This option has potential for a sub-optimal result because there is a grave danger that it is made without full visibility of underlying market conditions. The legislator has no clear or certain access to information about the internal finances of Telstra on which to base decisions.

- **regulatory remedies** (divestiture powers and cross media rules) i.e the provision of an additional remedy to the regulator to seek structural reform as a response to systemic anti-competitive behaviour and/or the exclusion of ownership across different modes of communications delivery.

This option is rules-based and overcomes the information asymmetry problem if the regulator is armed with sufficient powers of discovery to interrogate underlying financial information.

- **commercial remedies** i.e transparency of arrangements for non-commercial service arrangements, and freeing Telstra to make economically rational decisions maximising shareholder value

This remedy would continue to be at risk of abuse of market power arising from legacy advantages of incumbency, but would provide scope for policy innovation through use of investment incentives/penalties to overcome areas where market dysfunction was identified as warranting public intervention. (eg tax benefits limited to shared infrastructures; differential depreciation rules etc).

Comindico has publicly advocated in the past its support for a divestiture power remedy as the most effective means of remedying the structural failures in the telecommunications market.

It is our belief that the anti-competitive "hotspots" identified by the regulator – be they vertical elements of the infrastructure or geographic – provide the most precise indications of both bottleneck points and markets from which Telstra would withdraw if it was seeking to maximise shareholder value unfettered by legislatively imposed structural constraints. That is, Telstra, which is forced to retain activities in markets where its technology is inferior to newer alternatives, must logically resort to delaying the onset on competition to maximise its return from that investment without divesting itself of that activity.

Conclusion

Comindico submits that it is unclear if the proposition before Inquiry will be workable, but underlying problems that give rise to it will not go away. New regulatory remedies and investment incentives are necessary to overcome the core problems of Telstra's extensive market power and the consequent problems such as the reliance by other participants in the sector on access to bottleneck infrastructure from it as an unwilling seller. This is necessary to ensure that Australia has a robust telecommunications infrastructure and a competitive market for service delivery.

Comindico is available to assist the committee through the elaboration of the above points or to discuss any other issues that the committee considers relevant.

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