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Regulating Australian Telecommunications: Past Errors, Future Challenges

Henry Ergas[♦]

Coming as a young man to this brown, then much less wired, land from a childhood in continental Europe, I was impressed not only by its sparse beauty but also by the eccentricities of the locals. Central among these was a passion for sport – and what peculiar sports they seemed.

What was called football looked like little more than an excuse for senseless violence.

As for sailing, which consisted of hanging off the side of a small boat buffeted by wind and sea, it truly merged the pleasures of solitary confinement with the chance of drowning. Clearly, these were people willing to take pointless risks.

Finally, there was the pastime that combines the interminable with the incomprehensible, i.e. cricket. It is said of luxury yachts that if you have to ask how much one costs, you can't afford it. Equally, with cricket, if you have to ask what the rules are, you won't understand them. A love of thickets of rules inviting endless argument, then resolved through the essentially arbitrary – but seemingly highly respected – decision of an umpire, was plainly another important ingredient of the local scene.

That was several decades ago, but I am struck by the role those features – confrontation for its own sake, pointless risk-taking, uneasily combined with thickets of rules and an undue respect for arbitrary authority – have played in Australia's telecommunications history since the start of the reform process in the late 1980s.

First, there are no debates, only brawls. Participants rarely show genuine respect for each other's views, bring serious evidence to the table and resolve differences in the light of that evidence. Events like tonight's are very much the exception, not the rule.

Second, as the participants brawl, Leviathan has tended to do its thing, often with scant regard for credible analysis, pursuing goals that, though framed in high-minded rhetoric, are intensely political, at times basely redistributional, and that can impose needless risks and burdens on the community.

And third, there is an entrenched faith in the ability of umpires, operating under rules that give them great discretion, to make judgments that, rather than reflecting their own preferences, aspirations and interests, will soar dispassionately above the fray and 'make the right call'.

This combination does not make it easy to achieve happy outcomes. Its consequences have been aggravated by deficiencies in checks and balances.

♦ Concept Economics. The views expressed in this presentation are entirely my own, and should not be attributed to any of Concept Economics' clients.

This is partly due to the weakness of civil society and, despite the sterling efforts of ventures such as The Sydney Institute, especially of effective centres of analysis that do not depend largely or completely on the state.

Long ago, F.W. Eggleston lamented that there are no free-standing Australian intellectuals; rather, he said, our intellectuals are almost entirely institutionalised, and as a consequence, too often reluctant to speak truth to power. This helps engender and perpetuate a situation in which there is far too little rigorous scrutiny of crucial decisions.

Policy centralisation then compounds the problems. Australians often congratulate themselves on the wisdom of the fathers of Federation in giving the Commonwealth complete control over telecommunications. This, it is claimed, allowed the incompatibilities that afflicted the development of the rail network to be avoided (although Canada and the United States, in which the communications and transport powers were at least partially devolved, seem to have avoided those incompatibilities). But even if one concedes that view of history – and I would not – centralisation exacts costs of its own. It not only reduces the scope for policy experimentation but even more importantly, relaxes the constraints on bad policy, as the policy-making jurisdiction both has deep pockets and faces little threat of exit. And to make matters worse, it gives swing or veto players, such as the rural areas or (particularly and peculiarly at crucial times in telecommunications) Tasmania, the ability to exact inefficient side-payments they neither merit nor – in a more decentralised system – could ever have hoped to obtain.

The result of this toxic brew in telecommunications has been a system that is confused in its objectives and in its design, discretionary and at times capricious in its application, and shows little ability to sustain efficient outcomes or to correct its own deficiencies.

The seeds of that system in its current form were sown in the decision to create a regulated duopoly between the merged Telecom and OTC and what later became Optus. That regulated duopoly – which I argued strongly against, including at The Sydney Institute – embodied a belief in a form of 'managed competition' whose substance amounted from the start to little more than infant industry protection. The outcome confirmed what Australia's century-long experiment with protectionism already convincingly showed: that the infant, far from growing up into a strapping and self-sufficient youth, had every incentive to invest in preserving the protection for as long as possible, while the regulator, whose job was centrally tied up with supplying that protection, understandably showed no inclination to commit euthanasia. The legacy, passed on to the new regime when the duopoly ended in 1997, was an expectation that the regulator would manage market outcomes, in a form of social engineering that has failed exactly as often as it has been tried.

The ACCC, which in 1997 took up the regulatory role with even greater discretionary powers than had been vested on its predecessor, AUSTEL, showed little hesitation in continuing on the social engineering path. Two elements stand out in this respect.

First, confronted with the crucial but difficult task of setting third party access charges to Telstra's network, the ACCC chose a methodology that gave it the greatest discretion over the determination of those charges' level.

Second, having secured that discretion, the ACCC steeply reduced the level of the allowed access charges, slashing them at rates far greater than those observed in the United States, Canada or the EU.

Two consequences followed.

First, economics may be an uncertain science, but one principle is clear: if you reduce the price of something, more of it will be consumed and less will be consumed of its substitutes. In this case, the good that more was consumed of was access to Telstra's network by third parties, such as Optus. The substitute good, for which demand fell, was use by those third parties of networks of their own. This became ever more pronounced as access charges were cut further and further, with Optus, Transact and other putative builders of alternative networks shifting ever more of their use from those alternative networks on to Telstra's. If Telstra's network was not a monopoly to begin with, this was a fine way of making it one.

That this would be the outcome is hardly surprising. Justice Breyer, of the United States Supreme Court – probably the leading US jurist in economic matters – put it well in noting that in telecommunications, third party access regimes have tended to produce not a competitive market but rather its very opposite, because they have provided such strong incentives for putative competitors to merely rely on the incumbent's facilities. Moreover, Justice Breyer found the argument the regulator put – that the mandated sharing would provide a springboard for fledgling competitors' expansion – unconvincing, for, in his words, "why, given the pricing rules [which always set price on the basis of a hypothetically fully efficient network] would those 'fledgling competitors' ever try to fly on their own?". The Australian experience confirms the wisdom of Justice Breyer's doubts.

Second, basic economics also shows that when you cut the price of a good, you reduce the incentive to invest in its production. Unsurprisingly, Telstra's willingness to renew its access network wilted as access charges came down and as the risks associated with committing further shareholder funds rose. Equally unsurprisingly, this brought howls of protest from those – not least country users – who felt that as far as telecommunications is concerned, they deserved nothing but the best, especially when the price was to be paid largely by others.

One might have thought this situation could not last. But last it could and did, essentially for three reasons.

First, when carrots fail, there are always sticks to fall back on. As the Emperor Nero famously discovered from his pioneering efforts at price control, governments can regulate to compel supply, at least for a while, and that is precisely what was done. Specifically, we had a proliferation of regulatory requirements that, under the guise of protecting service quality, obliged Telstra to invest or face draconian penalties. Unfortunately, the targets set for the mandated service levels were entirely arbitrary,

and despite repeated calls from the Productivity Commission, were never subjected to any form of cost-benefit analysis.

Second, the remaining cracks in the firmament were tackled by throwing money at programs whose aim was to expand the reach of high speed services. Disappointingly, no cost-benefit assessments were ever made of this spending; my own estimate is that some $2 billion was wasted, that is, outlaid on projects whose benefits fell short of their costs.

Third, however misconceived the policy may have been, it found many supporters. The ACCC was one, and as a powerful advocate for its own cause, it secured both considerable legitimacy and a spectacular increase in funding. So too were the access seekers, a small and well-organised force, who, at least in the short run, gained when access charges fell. As for consumers, the low access charges did permit growing diversity in supply, especially in metropolitan areas, and placed greater competitive pressure on Telstra, though (as one would expect in the presence of inefficient entry) retail prices remained relatively high, and indeed, declined no more rapidly than they had pre-liberalisation. In the meantime, the costs were being shifted on to poorly organised groups, including the unfortunate purchasers of Telstra shares and the even less well represented taxpayers and consumers of the future.

Paradoxically, as this situation was playing itself out, reforms in the energy industries sought to address the very problems that were proving so harmful in telecommunications. Largely because the States had a strong interest in energy supplies – and in any event, were unwilling to hand a regulatory blank cheque to the Commonwealth – regulatory discretion was pared back, with the functions of setting policy, translating policy into clear and predictable rules, and then implementing those rules, separated out of the ACCC and vested in distinct authorities. While far from perfect, the resulting structure avoided the worst conflicts of interest that permeate the institutional arrangements in telecommunications, and gave some transparency to the process of setting and implementing rules.

In contrast, in telecommunications, a detailed inquiry by the Productivity Commission, which recommended narrowing regulatory discretion, was unfortunately ignored – in fact, in its wake, what accountability there was in the regime was weakened further, as part of the concessions the Commonwealth made to get the second tranche of Telstra's privatisation through the Senate. The result was a progressive deterioration in the situation, culminating in the highly publicised stand-off of recent years.

In saying this, I recognise that there is a competing diagnosis, which views the root problem as being Telstra and its vertical integration, and which sees structural separation as the cure-all for our telecommunications woes. That diagnosis has received recent support from the ACCC in its Submission to a review that Government is now undertaking into future regulatory arrangements. In my view, both this diagnosis and its resulting prescription are flawed.

Let me start with the diagnosis. The fact of the matter is that looking across countries, we observe a range of outcomes in every dimension of telecommunications performance. There are now several reputable studies, whose results are open to

replication, that examine those outcomes and find that a key determinant is the level of access charges. Set low access charges, and facilities-based competition will not emerge, or where it has emerged, will fail to develop. This is, of course, what I argue has happened in Australia.

In contrast, comparative studies find little evidence that vertical or horizontal integration by the incumbent has any adverse effect on telecommunications outcomes. Nor is there a reputable study I know of that suggests that performance is generally better in countries where structural, functional or operational separation has occurred than in those where it hasn't. Indeed, even casual observation suggests otherwise: Telenor, for example, which is far more vertically and horizontally integrated than Telstra, is one of the world leaders in both mobile and fixed networks, with Norway having high levels of broadband access; the same can be said for the Danish telecommunications company, which again, is more vertically and horizontally integrated than Telstra; in contrast, BT and Telecom NZ, which are both proud of their functional separation, struggle to provide high quality broadband service in their respective countries and the situation in the UK and NZ does not appear to have improved materially, when compared to other countries, since separation. Equally, as several studies have now found, Bell Canada, which is vertically and horizontally integrated, appears to have performed better than many of its structurally separated US counterparts.

This brings me to the proposed remedy – separation, in one form or another. There is, in this respect, a growing consensus among economists – one that, of course, falls well short of unanimity but (given how readily economists disagree) is still surprising in its prevalence. Thus, Professor Eli Noam, head of the telecommunications institute at Columbia University and one of the world's leading experts in telecommunications economics, has for many years been a leading advocate of separation; yet he wrote recently in the Financial Times that while he had long "strongly supported" separation, examination of its outcomes convinced him that "structural separation may have made sense in theory, but the numbers do not substantiate the benefits in practice." While Professor Noam still believes structural remedies has a place as an absolute last resort under the anti-trust laws, many other economists have echoed his findings as to its inefficiency. Thus, the eminent regulatory scholar Paul McAvoy, Professor of Economics at Yale University, has recently concluded, again on the basis of analysing the data, that separation in the US was followed by increased price-cost margins and at least in that sense, harmed consumers and reduced the effectiveness of competition, while Robert Crandall of the Brookings Institution, by measuring changes in consumer welfare in a range of countries, has found that there were no consumer benefits in most of the countries mandating some form of separation, and in the one country in which there were such benefits, they could have been achieved at lower cost through improved access regulation. All this is also much as economics would predict: for while vertical and horizontal integration can and in some cases does create scope for anti-competitive conduct, they also bring a wide range of benefits in terms of technical coordination, pricing efficiency and capacity to innovate. Set against those benefits, separation – which always has real costs – does not seem to stack up.

If separation is not the answer, what then should have been done? Simply put, my view is that we should have addressed directly the disincentives the current

arrangements create to efficient investment and pricing. My book lists six major sets of changes, all incremental to the current arrangements, that would have preserved existing competition, while placing clearer and more predictable bounds on regulatory discretionary. Once implemented, those changes would have allowed us to rely on private decision-making and risk-taking to take us forward.

But whatever should or should not have been done may now seem of merely historical interest, for the government appears to have cut through the situation with its commitment to build, likely at high cost, a new national broadband network ("NBN"). It would, I believe, have been preferable for a careful cost-benefit study to have been undertaken, and released for public scrutiny, before deciding to proceed with a project that could be so costly, complex and risky. That said, the Government's decision marks a significant change and requires us to look forward, rather than back. In doing so, we need to confront new policy challenges that the NBN itself raises. Stressing once again that these views are very much my own, allow me to focus on seven elements that I believe to be of particular importance.

First, it remains crucial to have a policy and regulatory framework that can provide incentives for efficient investment, be it by the entity responsible for the new network, or by its competitors. This must, in my view, involve setting out clear principles in legislation for determining regulated prices, and particularly for permitting the recovery of costs prudently incurred, as compared to the confused, conflicting and ultimately vague statements of objectives on which the current legislation relies.

Second, it needs to be recognised that there are substantial dangers in recreating a situation where there is a conflict of interest between the government's role as policy-maker and regulator on the one hand and its role as owner of a major competitor on the other.

Were such a situation to eventuate, it would increase the importance of securing far greater transparency around, and far greater accountability in, the regulatory process. There is, in this respect, considerable merit in clearly separating the functions of determining and issuing policy guidance, translating policy into carefully specified rules, and actually applying those rules through regulation. Such a separation provides scope for enhanced transparency; having carefully specified rules, especially with respect to access pricing, this will also make for more effective review of regulatory decisions by the Australian Competition Tribunal, assuming it retains its review role..

Third, complex competition issues are raised by any structure that involves a joint venture between the industry's main participants, who then all rely on the wholesale services the joint venture provides. Such arrangements have, in other contexts, created dangers of collusion, and even absent such collusion, can impose a uniformity of competitive conditions, underlying technologies and cost structures that is inimical to vigorous rivalry. Were such a joint venture approach adopted, it would be important to limit any cooperation as strictly as possible, and maximise the scope for participants to differentiate the range of applications and services they provide.

Fourth, there must remain full scope for networks that compete with the NBN. The international experience provides little support for the notion that the new network will or should be a monopoly. It provides even less support for legislative restrictions

on competition. Rather, the NBN can and should compete both with existing networks – be they cable, copper or wireless – and with the entirely new technologies that continued innovation will create. So as to protect that competition, the Trade Practices Act, including the prohibitions on anti-competitive mergers, should apply, *inter alia* to any transfers of assets into the new entity. The NBN should not be an opportunity for investors, such as SingTel Optus, to offload poorly performing or badly managed assets on to the Australian taxpayer; rather, if they are not willing or able to put those assets to good use, they should go to owners who can, and remain as sources of competitive pressures on the new network.

Fifth, if costs are to be minimised, the venture's governance structure will need to avoid the inefficiencies that have plagued other infrastructure joint ventures, such as the open access coal loaders on our Eastern Seaboard. Experience with those joint ventures highlights the dangers involved in granting disproportionate weight (or even worse, veto rights) to minor players, who can benefit by cost-shifting or by 'holding up' other market participants. Overall, misalignments between decision-making powers and incentives are fatal to long term efficiency, yet they have been a recurring feature of our open-access infrastructure facilities.

Sixth and related, realism is required about the costs and benefits of vertical separation, i.e. of a wholesale-only network. In government, there are gains to the separation of powers, as Montesquieu pointed out more than two hundred years ago; the opposite is generally true where building complex networks and operating them on a commercial basis is concerned. In this specific context, separation could raise costs both in the transition to a new network and in the longer term.

As far as the transition is concerned, designing and constructing a new fibre optic network and then shifting to it some 8.5 million services at about 5 million premises, all in a relatively short space of time, is an immensely complex exercise that is fraught with risks. A new wholesale-only operator would struggle to undertake that transition with anywhere near the levels of cost-effectiveness, service assurance and service continuity that the community demands.

As for the longer term, separation causes the loss of significant technical economies of scope, including in fibre networks; but even were the many technical problems with separation overcome, economic inefficiencies would likely persist, including the fact that access prices are unlikely to reflect marginal (rather than average) costs and more broadly, that incentives will be misaligned between the network company and the retail service providers, creating scope for harmful cost-shifting games. Overall, it may be possible to separate from downstream operations ownership of the purely passive elements in an NBN – such as conduits and even the unlit fibre – but going beyond that could raise serious risks.

Seventh and last, it is crucial that the project not entrench the geographical cross-subsidies and other pricing distortions that have bedevilled Australian telecommunications since the 1920s. Gareth Evans, as Minister for Transport and Communications, took the first steps to try to bring transparency to those cross-subsidies, allowing time to then bring them under control. The Howard government, to its credit, also sought to rely more heavily on transparent, budget funding than on distorting price controls. It is important that the moves that have been taken in the

direction of unwinding cross-subsidies be preserved, and that we go forward in limiting and rendering explicit any subsidies for non-commercial operations.

In short, the government's announcement does not cut the Gordian knot of our current predicament; rather, it highlights the need to remove the current regulatory blockages in a way that can open the road both to entirely new networks and to their competitors, giving market forces the primary responsibility to determine ultimate outcomes. Failure to do so will merely compromise further the efficiency of our telecommunications system, which is now so vital to Australia's prosperity and central to our daily lives.

There is, in other words, still everything to be done. In saying this, I am reminded, and I will close with this, of one of the finest books I have read about this country. In Hancock's magnificent Australia, now sadly out of print, the great historian famously said that it was a failing of democracies, and especially of Australian democracy, to constantly confuse ends and means, and to show too much reluctance "to refuse favours, to count the costs, to discipline the policies they have launched". "[The] policies therefore yield diminishing returns, until at last, they may become a positive danger to the national purpose that called them into existence".

Nowhere was this more marked, Hancock noted, than with public involvement in ventures such as rail, where Australian government was "particularly slow to confess it has got into a bad business, for its mere entry .. has created vested interests which immediately express themselves in politics.. So.. it throws good money after bad, and hopes that something will turn up. In this way, losses accumulate in a lump, and the crisis, when it comes, is likely to be prolonged and severe."

Mutato nomine, de te fabula narratur? Is this, name changed, the story of our telecommunications future foretold? The best hope of avoiding it is for the country to debate these issues in an open, serious and serene way. I congratulate both Paul Fletcher and The Sydney Institute for contributing to that all too rare process, and thank you for your kind attention.