ATUG's submission to the House of Representatives Standing Committee on Communications, Information Technology and the Arts Inquiry into the structure of Telstra

1) HOW COMPETITIVE IS THE MARKET?

ATUG's views on the key question for the inquiry, namely how competitive is the Australian telecommunications market, are based on its surveys of business users.

Top 100 Survey
ATUG's Top 100 survey conducted in April/May 2002 revealed the following conclusions of relevance to this Inquiry:

1. Telstra's dominance among Top 100 companies is comprehensive. 30% of those interviewed use Telstra exclusively, even though most of these companies have previously used other carriers. Moreover, most companies using multiple carriers limit their usage to two and in the vast majority of cases Telstra is the main supplier, typically capturing around 80% of the company's annual telecommunications budget.

2. Reasons for Telstra's continuing dominance relate largely to its network reach, and the economies of both scale and scope. Put simply, there are many products and services demanded by Top 100 companies that only Telstra provides.

3. Significantly, there is very little use of resellers among Top 100 companies. There is a clear and consistent preference for dealing directly with carriers that own and operate their own networks. For this reason, after Telstra, Optus emerges as the next most widely used provider and remains the only other carrier to have had a significant impact in the large corporate segment.

4. Among locally based carriers AAPT/Telecom New Zealand, PowerTel, UeComm, RSL Communications and Macquarie Corporate Telecommunications have made some inroads into the Top 100 – but to a very limited extent. Among global service providers, only BT, Equant, MCI Worldcom and Infonet rated a mention.

5. Some Top 100 companies have been willing to consider using Vodafone and Hutchison for mobile service, but these two companies have been largely unsuccessful in winning business from large corporations. This is despite substantial direct investment by both companies in their own networks. There is also a perception among the Top 100 that mobile services are one of the main areas where competition hasn't worked. The basis of this assessment is that the non-Telstra networks don't have adequate rural and regional coverage; and that there is insufficient price and product differentiation in mobile services.

6. While Telstra continues to attract criticism for its "complacency", "arrogance" and "public service mentality", corporate users frequently concede that these problems are less acute now than 5 years ago. Importantly, these criticisms were less frequent that the praise given to Telstra for its improved marketing, reduced prices, greater flexibility and responsiveness, diversified service offerings and efforts to improve service generally.

7. Assessments of the performance of new entrants were also mixed. The main criticisms related to lack of depth in product offerings, reliance on Telstra for network coverage and support, failure to deliver on promises, "hopeless" service and various forms of added cost and inconvenience in having to manage an independent carrier while also dealing with Telstra. Offsetting these negative assessments were views that entrants were easier to deal with than Telstra, provided services at lower cost, mitigated operating risk through network diversity, in some cases have superior capabilities based on specialisation, and, in some cases, there was a willingness to package services more attractively than Telstra (eg by selling dark fibre).

8. While it is fair to say that many companies see competition as being beneficial and having delivered some positive outcomes, there are four key areas of concern:

   - Telstra's continuing dominance is linked to its network reach and coverage, particularly in regional areas;
   - There is an expectation that prices should fall further;
   - Mobile and data services are two areas where competition is seen to have delivered little or no benefit, while broadband has been slow to develop due to cost and supply constraints; and
   - Competition is not seen in terms of how many suppliers exist but how effective they are – and for some respondents, at least, there is a view that fewer competitors, each operating on a larger scale, is preferable to a market comprised of Telstra plus a large number of niche and small companies.

Users face a conundrum – to get the coverage and product range they want, often Telstra is the only provider capable of meeting the full needs.

The user's experience is not one of buying in a strongly competitive market. Users point to examples such as high prices for leased lines, high prices for mobile and fixed to mobile calls, use of the Standard Form of Agreement in contracts with corporate customers and complexity as evidence of a market still dominated by one supplier.

SME research

ATUG is currently conducting research into competitiveness in the SME sector. Preliminary findings from this market reveal:

1. Communications and IT are regarded as critical to business by 90% of the businesses surveyed (sample size 313, national and regional companies).
2. Fixed phone is considered to the best value service ahead of Internet
3. Mobile phones, although a high usage service, are clearly considered to offer the least value
4. 55% of SMEs use an intermediary for access to some part of their communications and IT services.
5. The most important communications and IT services are fixed phone and fax, computer equipment and mobile phones and the Internet.
6. Expenditure on communications services has increased over the last twelve months.
7. 61% of businesses ranked expenditure on Total Communications and IT services in the top 5 expenses for their business
8. In the key product lines (fixed phone and fax, mobiles, 1800/13 numbers, broadband, and other data services) Telstra is earning over 80% of the total revenue. Only in Internet services do we see strong competition with Telstra only earning 44% of the sample revenue.
9. The SME sample indicated the best communications companies were – Telstra (65%), Optus (19%), Vodafone (5%)
10. The following reasons were given: Telstra – familiar and satisfied, biggest/oldest company; Optus – competitive rates; Vodafone – service/products are good.

The use of intermediaries in this segment means there is less concern about providers owning their own networks; and the importance of the "core" services – phone and fax – reinforces the significance of competition in delivering price and other benefits to end users.

2) HOW EFFECTIVE IS THE CURRENT REGULATORY REGIME?

The second issue for consideration is the effectiveness of the current regulatory regime in promoting competition.

ATUG's concerns about the robustness of the regulatory regime are well known. They were articulated most recently to the Senate Inquiry into the Australian Telecommunications Network, August 2002 (attachment 4):

"The objective of open competition in telecommunications was (and must remain) to promote the long-term interests of end users and the efficiency and international competitiveness of the Australian telecommunications industry.

However, there are a number of tensions between these policy objectives and what has been achieved in practice.

It is increasingly clear that users cannot rely on the market and self-regulation to deliver outcomes.

After five years of open competition in telecommunications, we now know:

- A privatised incumbent operating in a competitive industry will always focus on maximising shareholder returns – forget promoting competition or end user interests
- The "light touch/industry self-regulation" approach has not been effective in protecting end users – and must be reversed
- The focus on process rather than outcomes has lead to delay rather than decisions – we need time limits and transparency for all decisions about access
- The "one size fits all focus" on infrastructure (facilities) competition rather than services competition has resulted in wasted capital and a negative reaction from the capital markets to further innovation
- The size and spread of the market have created difficulty in diffusing competition beyond the CBDs. Progress has only been achieved by direct Government funding
- Users need much clearer, cost-oriented supervision of pricing

A combination of regulatory focus and Government funding has been essential to securing outcomes for end users. The market alone has not delivered the results. The Customer Service Guarantee, The Universal Service Obligation, the new ACA National Reliability Framework for Monitoring and Reporting on Quality of Service, ACA mandated Mobile Number Portability are all important regulatory tools. In addition Government funding and industry funding for USO obligations has provided in the order of $1 billion direct funding for development of services in regional, rural and remote Australia.

The role of the ACCC has been important in achieving the basis for competitive wholesale offerings on call services, access services, mobile services and lately broadband services."

Since that submission, further amendments (November 2002) have been made to the Trade Practices Act but these have not yet been fully implemented and ATUG's concerns about the effectiveness of current regulation remain.

3) HOW DO WE ACHIEVE A MORE EFFECTIVE TELECOMMUNICATIONS MARKET?

Whether structural separation is the right answer needs careful analysis. There are pros and cons from the user's point of view and it is difficult to make comments in the absence of a detailed model to consider. The questions which need to be reviewed are outlined in Attachment 3 – extract from the OECD Working Party on Telecommunications and Information Services Policies report **The Benefits and Costs of Structural Separation,** Paris, December 2002.

But other regulatory initiatives may also be relevant. For example the current EU regulatory approach (referred to in the OECD report on Structural Separation) is quite different to the Australian approach. The EU introduced its new regulatory framework for electronic communications networks and services as recently as March 2002 and it is yet to be transposed into national law, mandated by July 2003.

The Commission of the European Communities eighth report (Brussels, 3.12.2002) on the Implementation of the Telecommunications Regulatory Package - European Telecoms Regulation and Markets, 2002 makes a number of relevant comments on further regulatory adjustments in the EU that may be of relevance to Australia. These include the identification and regulation of companies with Significant Market Power, how to achieve regulatory independence and progress with accounting separation.

Approaches such as these ought to be considered as part of any deliberations on more effective regulation of the telecommunications market.

For example, **regulatory independence**, pg.18:

> "Remaining concerns relating to regulatory independence under the current framework should be removed in Belgium with the forthcoming adoption of legislation designed to confer on the regulatory body powers currently held by the minister responsible for the State shareholding in the incumbent operator.
>
> Two models for the assignment of regulatory powers have evolved. In some Member States an independent and autonomous body or agency exercises the full range of powers including those relating to licensing, interconnection, access, price controls, frequency assignment and numbering (Germany, Greece, Ireland, Austria, the Netherlands except for frequencies, Portugal), while in the others the regulatory body exercises regulatory powers to a greater or lesser extent with the relevant ministry. The dispersal of powers inevitably leads to a reduction of the regulatory certainty required by the market, in particular in cases where decisions by ministries relating to licensing or price controls may be seen by the market as being influenced by political considerations. Leaving aside such considerations, the overall performance of the independent body may quite

> simply be improved through the transfer of all regulatory powers from the ministry, as has been the case for example in Greece."

The implementation of **accounting separation**, pg.37:

> "There are therefore still significant aspects to be improved across the EU before implementation of accounting separation can be regarded as satisfactory.
>
> The implementation of cost accounting and accounting separation in Ireland and in the United Kingdom can be regarded as best practice in the EU as regards the approach and methodology used, the detail of the verification carried out by the regulators and the availability of information to third parties. All these elements result in greater transparency of the tariff determination process and contribute to establishing confidence in the cost accounting systems of the notified operators and indirectly in the cost orientation of tariffs."

CONCLUSION

Over the last couple of years, ATUG and many other groups have been responding to various efforts by the Productivity Commission, Parliament, the Department, the ACCC, and the ACA directed at achieving an effective, competitive market for telecommunications services. ATUG has included extracts from relevant submissions as attachments to this submission.

The increase in such activity in the last 2 years is practical evidence that we have not yet achieved the objective of robust competition in telecommunications. Findings from the Estens Report, the Foxtel/Optus Content sharing agreement and the Broadband Advisory Group all raise questions as to the adequacy of current regulation to deal with developments in telecommunications.

The matter of whether structural separation is the next step is complex and any proposals need to deal with the detailed questions suggested by the OECD report before they can be properly considered.

Structural separation, whether mandated or managed within Telstra, whether of core business or non-core business, whether of telephony businesses or pay TV interests, needs in depth investigation similar to the Productivity Commission's review of telecommunications specific regulation. It should be noted that Structural separation was excluded from The Terms of Reference for the 2000/2001 Productivity Commission Review of Telecommunications Specific Competition Regulation.

The next section of this submission deals specifically with the Committee's Terms of Reference.

ATUG Comments on the Committee's Terms of Reference

That the Committee inquire into and report on the economic and social impact of structurally separating Telstra's core network from its other businesses and reducing the Commonwealth's current shareholding in Telstra's non-network businesses.

In conducting its inquiry, the Committee should consider the impacts of such a proposal on:

- **The efficient provision of services to end-users, including businesses and residential customers in regional, rural and remote Australia;**

ATUG comments:
The issue at hand is whether there is sufficient competition in telecommunications to maximise the objectives set for the industry – namely, the long-term interests of end users and the international competitiveness of the industry.

It is clear (Estens, Broadband Advisory Group) that certain markets will not be addressed adequately by regulation alone. These markets need new answers.

It is also clear that the current model of regulation which depends on identifying market failure before action is taken means unacceptable delays for end users.

The EU has recently adopted a different approach to regulation of dominance i.e., companies with Significant Market Power face higher levels of regulation. Structural separation is one model for dealing with dominance but a review of other models ought to be part of the Committee's deliberations.

- **Telstra's ability to continue to provide a full array of telecommunications and advanced data services;**

ATUG comments:
The issue for ATUG is identifying ways of encouraging competition from other suppliers across the full range of services. Corporate users see lack of product depth as a concern in regards to the viability of competitors' offerings.

In addition, the emergence of bundling and the ramifications of recent developments in PAY-TV in regards to a single gateway to the home, replacing the local loop as an access bottleneck, need careful assessment and response.

The question is not whether Telstra can continue to provide a full array of services but whether any other competitors are able to.

- **Ongoing investment in new network infrastructure;**

ATUG comments:
The delay in broadband rollout and the work of the Broadband Advisory Group and the findings of the Estens Report suggest that the current system of regulation is not ensuring ongoing investment in new network infrastructure.

The work of the ACA in the National Reliability Framework will provide information on the current adequacy of investment in the network infrastructure. The information obtaining from the implementation of accounting separation may also provide information on which to make an assessment as to adequacy of investment in infrastructure.

Users worry that the focus by equity markets on % of capex to revenue seems to be the key factor in such decisions at present.

- **The wider telecommunications industry;**

ATUG comments:
ATUG is aware of the dissatisfaction of the wider telecommunications industry with progress in competition to date, their concern about whether recent amendments to the regulatory framework will deliver a better result, and concern with slow development of new services which impacts on the equipment sector in the industry.

- **The telecommunications regulatory regime**;

ATUG comments:
The number of reviews in the past twelve months that have raised questions about the telecommunications regulatory regime indicate that it is time for a comprehensive review of our approach to regulation of the telecommunications market. Any assessment of structural separation should be done as part of the wider review.
The question is whether we are taking the right approach to the regulation of telecommunications, given that after over 6 years experience with the current approach, strong competition has not emerged and the telecommunications market has changed significantly in that time.

ATUG is not advocating short-term responses to change.

Structural separation should be one option under review - Significant Market Power, amalgamation of regulatory bodies like OFCOM or the FCC, full transfer of regulatory power from the Minister to such a body, are other matters which should be canvassed.

ATUG's views on the problems with the current are outlined in the body of the submission. Information about the EU approach is also in the submission.

- **Telstra's shareholder value and its shareholders**; and

ATUG comments:
ATUG understands that some analysts suggest structural separation would have negative impact on share price, others suggest that infrastructure and services are different sectors and that sharper focus on each would increase share price.

It was not too long ago that the management model of "Excellent Customer Service" was seen as a predictor of success for companies. The interests of customers and shareholders need to be in balance given the social and economic impacts of the telecommunications industry.

- **The Commonwealth Budget**.

ATUG has previously made submissions on a Rural Infrastructure Fund designed to address the development of infrastructure in markets that are not competitive. This approach has resonance with suggestions in both the Estens Report and the Broadband Advisory Group Report that other approaches need to be considered when market based approaches do not work. These matters need to be considered along with the option of structural separation.

Attachments

1. ATUG Company Profile
2. ATUG Focus Policies
3. OECD Report on Structural Separation
4. ATUG submission to Estens Review
5. ATUG submission to Senate Inquiry
6. ATUG Rural Infrastructure Fund

Attachment 1 - ATUG Profile

ATUG was established in 1980 by a number of corporate users of telecommunications with the purpose of achieving a de-regulated telecommunications market. ATUG's mission is to achieve world class telecommunications services at world class prices for Australian businesses.

ATUG seeks to influence government, regulatory bodies and suppliers to ensure they contribute positively to the ongoing development of the communications industry.

ATUG actively promotes the use of telecommunications as a strategic resource that business can use to improve both efficiency and market position.

ATUG endeavours to ensure its members have the necessary knowledge to make the best use of modern communications services through regular branch meetings, workshops, focus groups and peer-to-peer activities conducted in all Australian states.

ATUG is a member the Government's Broadband Advisory Group.

ATUG is a member of the ITT Industry Training Advisory Board.

ATUG has been appointed Vice Chair Asia Pacific Region, International Telecommunications Users Group.

ATUG is a member of the ACA's Consumer Consultative Forum.

ATUG is represented on the Board of the Australian Communications Industry Forum.

ATUG is represented on the QLD Government Communications Information Advisory Board

Attachment 2 - ATUG Focus Policies

ATUG's Objective
To achieve high quality telecommunications services at OECD benchmark prices for Australian businesses.

Competition
ATUG supports sustainable competition as the best way to deliver choice, reduced prices and innovation. In some areas, ATUG believes competition has stalled. Proactive involvement by government and regulatory bodies is needed to achieve more timely outcomes for the long term benefit of end users. Prices for telecommunications services should be cost related.

Open Access
ATUG believes practical equality of access to the Local Loop and PSTN, on fair and reasonable terms and conditions, is essential to effective competition. This has not yet been achieved. The ACCC should determine and make publicly available indicative prices, terms and conditions for supply of critical network services.

Broadband Connectivity
The benchmark for communications connectivity is affordable always-on broadband access at minimum 256Kbps. Strong competition in service delivery, government initiatives and policies to support content development will accelerate take-up.

Mobiles
ATUG will work for significant reductions in international roaming and fixed-to-mobile charges.

Users should have access to the most extensive network coverage possible. ATUG will work to achieve national roaming between carriers on fair and reasonable terms and conditions.

Informed Choice
Telecommunications contracts are too complex. They should be in plain English format, readily understood by the users of the services to enable "fit for purpose" choice of service quality and fairer negotiation of prices.

Regional Telecommunications Services
Fairly priced up-to-date communications services are essential for economic and social development in regional, rural and remote Australia. Policies must be put in place to support the development of such services in cases of market failure.

Attachment 3

OECD Working Party on Telecommunications and Information Services Policies report The Benefits and Costs of Structural Separation (Paris 2-3 December 2002), at page 3-4.

"MAIN POINTS

The blame for the problems relating to access and the disappointingly slow progress of Local Loop Unbundling (LLU) has been attributed by some (especially the new entrant operators) to the incumbents' anti-competitive conduct. Incumbents have been accused of engaging in anti-competitive activities such as 'price-squeezing', delays and cost creation, offering an unattractive mix of exchanges for co-location, and also of exaggerating the difficulties of installing the requisite equipment. Indeed, the incumbents' competitors argue that the use of such tactics is only to be expected since an inherent conflict of interest exists when a vertically integrated incumbent operates as both supplier and competitor in the local exchange market.

The concern with facilitating the availability, cost and take-up of broadband has raised the stakes in regard to LLU. This is because LLU would allow competing telecommunications operators to 'co-locate' their equipment in the exchanges of the incumbent and thus gain direct access to the copper loop that goes to nearly every home and business. Through digital subscriber line (DSL) technology, LLU would allow telecommunications operators wanting to provide advanced services to reach customers without having to build a new local access network.

Supporters of structural separation argue that it would: bring the incumbent's incentives into alignment with a non-integrated carrier, thereby guaranteeing non-discriminatory access to (components of) the incumbent's networks and thereby promoting competitiveness; by promoting access and LLU in turn promote innovation (such as that required for the delivery of high speed Internet) either by new entrants or by the incumbent which would now be under increased pressure to do so (to avoid new entrants acquiring the competitive edge); create a level playing field by forcing the incumbent's wholesale arm to deal with its retail arm on the same terms that it deals with any other retail competitor (implicitly solving interconnection issues as well); allow the management of a structurally separated incumbent to focus on the wholesale portion without the need to consider the impact of its policies on the retail division, and this should improve efficiencies; allow regulators to focus on the wholesale network to guarantee service quality, network reliability, and access to essential network facilities at cost-based prices; be simple compared to behavioural remedies; be effective, while behavioural regulation that runs counter to an incumbent's inherent incentives, cannot be fully effective; improve information and help eliminate cross-subsidisation; and reduce the need for regulation because the change in incentives decreases the need for government oversight.

With the LoopCo approach, ownership and control of the incumbent's access assets and business -- primarily the local loop -- would be separated from its non-access business and activities and transferred to a new company, LoopCo. This new company would then provide wholesale access services to other companies at a regulated price. The 'RetailCo' incumbent would then compete for all non-access services and would contract with LoopCo for its wholesale services as any other company would.

The NetCo proposal involves separating an incumbent's access and switch networks into a separate 'network' company that then treats all retail operators in an equivalent manner.

The so-called 'ADCo' proposal involves club or joint ownership of a "carriers'-carrier".

While seemingly simple in concept, in fact structural separation is far from simple to implement. There can be a formidable range of difficulties and a wide range of questions to be answered. And the onus is fairly placed on the proponents of structural separation to provide persuasive answers that the drastic action they call for is necessary.

- What is the nature and scope of the structural separation being called for? Precisely what is involved in structurally separating an incumbent operator? In other words, since "the devil can be in the details", have the details of structural separation been clearly specified?

- What problem(s) is structural separation meant to be addressing? Is structural separation necessary?

- What technical problems will be faced and how will these problems be resolved?

- What impacts will structural separation have on investment and innovation to upgrade the local loop and how will any problems in this regard be resolved?

- How would a structurally separated 'NetCo' or 'LoopCo' operate and be managed?

- How would a structurally separated 'NetCo' or 'LoopCo' be regulated?

- How will cost increasing impacts of structural separation be contained?

- How will impacts on consumers be addressed?

- What changes in regulation will be needed?

- Are the benefits of structural separation demonstrably in excess of the costs?

- What is the policy position of authorities that have considered the use of structural separation?

- What convincing evidence can be tabled that structural separation is the most cost-effective approach to achieving the desired effects?

The arguments that structural separation is necessary are inconclusive. The issues and unanswered questions raised in this paper cast serious doubt over whether there is yet an adequately detailed model for the structural separation of incumbent carriers that can or ought to be supported.

There is uncertainty about the extent to which structural separation would result in changing the incentives of the incumbent towards facilitating competition. The problems of coordinating investment between the wholesale and retail parties could be considerable. The effect might be, in the worst case, to delay or even impede network upgrading, including the extension of fibre closer to the customer. Mandatory separation would threaten the loss/reduction of various efficiencies enjoyed by an integrated firm, including economies of scale and scope. There would also be considerable one-off costs of divestment.

The impact on consumers is uncertain. If competition strengthens significantly, prices could fall, and innovation, quality of service improve. But there is inadequate evidence to generate confidence that this will happen. Moreover, the significant costs that structural separation would generate is likely to be passed on to consumers resulting in price increases.
The paper concludes that the structural separation approach is risky with benefits that seem limited, uncertain, indeed, conjectural, with on the other hand, potentially significant costs including potentially adverse effects on network development. Certainly there is insufficient evidence that benefits would be convincingly in excess of costs.

Against such an assessment of structural separation proposals, it would seem sensible to persevere with improvements to the current regulatory approach backed with sanctions to deal with anti-competitive discrimination."