Chapter 2

Policy, regulation and competition[1]

Introduction

2.1 Reform of Australia's monopoly telecommunications sector began in the last decades of the twentieth century with the Telecommunications Acts (TA) of 1989, 1991 and 1997.

2.2 The process of competition development was slow, due largely to the presence of a dominant incumbent involved in both wholesale and retail telecommunications service markets, and the high risks and entry costs for facilities-based competitors. This environment ensured significant government involvement in regulation and the reform process.[2] As argued by one commentator:

> In Australia, as in many parts of the world, telecommunications services were provided primarily by a government-owned and operated monopoly until the latter part of the twentieth century. As those monopolies have been dissolved and new participants have entered telecommunications markets since the 1980s, a major policy task has been to ensure that those markets operate competitively. A critical part of that task has been to address the competitive advantages enjoyed by incumbents former monopolists, and to address issues arising when operators other than the incumbent exercise market power. Thus in Australia, as in other developed markets, the primary regulatory focus has been on restraining the exercise of market power by the incumbent network operator – in this case, Telstra.[3]

2.3 This chapter provides an overview of the policy and regulatory framework which developed in Australia to encourage competition in telecommunications. It examines current access regimes and regulations to address anti-competitive conduct and reviews recent episodes in which the ACCC found Telstra may have acted in an anti-competitive manner in regard to its wholesale pricing of high-speed Internet services and ADSL.

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1 The chapter draws heavily from *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004.

2 Alasdair Grant & David Howarth, The Access Regime, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.87.

3 David Stewart, Anti-competitive Conduct, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.158.

Transition to competition

2.4 Competition in the telecommunications sector began with the *Telecommunications Act 1989,* which opened 'value added' services and private networks to competition, yet which allowed the then Telecom to retain its monopoly over basic telephony services to ensure that services were delivered to regional and remote areas. Under this Act AUSTEL was established as an independent regulator to oversee this process and report on areas of further competition.

2.5 The transition from a monopoly network to open competition was set to occur between 1991 and 1997. The *Telecommunications Act 1991* broadened facilities-based competition as a limited number of carriers were granted 'exclusive rights' to enable them to roll-out new networks, recover some capital costs, and establish retail customer bases. These exclusive rights were given to carriers, as opposed to non-carriers, who were recognised as the 'primary providers' of basic telecommunications and satellite services. These carriers were permitted to discriminate in favour of themselves in the provision of services over their infrastructure. Under TA 1991, AUSTEL'S powers were expanded to allow it to address issues of competition and consumer protection, universal service arrangements and the access to carriers' networks by other carriers and services providers.

2.6 The liberalisation of Australian telecommunications markets proved contentious however:

> Between 1991 and 1997, many regulatory struggles were fought about competition issues, including those concerning Telstra's disputed continuing dominance of the mobile telephony and international services market; retail prices discrimination by Telstra; cross-subsidisation within Telstra's business units; and the pace of development of the service industry.[4]

2.7 The struggles which were being fought over telecommunications competition coincided with a national debate about competition policy more generally. In 1993 the Inquiry into Competition Policy in Australia (the Hilmer Report) argued that competition was critically important to Australian industry and it recommended that trade practices law be broadened in order to achieve a coherent and consistent regulatory framework which could apply across the whole economy.

2.8 In April 1995 the Australian, State and Territory governments agreed to a program of competition policy reform known as the National Competition Policy (NCP), a coordinated and systematic set of measures aimed at encouraging greater competition across large parts of the economy over (originally) a six-year timeframe. State governments took measures to introduce competition into their public utilities

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4 Holly Raiche, The Policy Context, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p. 9.

companies, such as gas, water, and electricity. Similarly, the Commonwealth sought to apply the Hilmer Report's recommendations to sectors over which it had jurisdiction, such as telecommunications. The Commonwealth had already been moving in this direction with TA 1991, however, the report was critical of this process and of the application of the *Trade Practices Act 1974* to telecommunications.

2.9 The Hilmer Report also recommended that the Trade Practices Commission and the Prices Surveillance Authority should merge to form the Australian Competition and Consumer Commission (ACCC), and that trade practices laws introduce an access regime for essential facilities under the *Competition Policy Reform Act 1995*.[5] The ACCC also took over from AUSTEL as the regulatory agency responsible for telecommunications competition.

Open competition

2.10 The key object of the 1997 reforms was to promote open competition in telecommunications services by abolishing legislative barriers to market entry and service provision. Importantly, the *Telecommunications Act 1997* removed much of the 'exclusive rights' which had benefited a number of carriers under TA 1991 and diminished the distinction between carriers and service providers.[6]

2.11 The Act developed a means of differentiating carriers from carriage service providers. Carriers were defined by ownership or control of transmission infrastructure that they or others used to supply carriage services to the public. Service providers were defined as users of carrier infrastructure to supply services to the public. However, these concepts were no longer mutually exclusive as they had been under TA 1991:

> Most carriers also operate as service providers by using their own infrastructure to supply services to the public; that is, by operating as vertically integrated operators in both access (upstream) and retail markets…. Service providers include both carriers and non-carriers. This simplifies the regulatory structure.[7]

2.12 Open competition in the telecommunications sector came into force on 1 July 1997, with a movement in emphasis from an 'industry-specific regulator administrating industry-specific regulation, towards a general regulator enforcing an access regime based upon general competition principles'.[8] The Act also enhanced

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5 Holly Raiche, The Policy Context, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.10.

6 Alasdair Grant, Industry Structure and Regulatory Bodies, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.23.

7 ibid, p.24.

8 ibid, p.87.

jurisdictional powers for the Telecommunications Industry Ombudsman (TIO), an industry funded dispute resolution scheme, to investigate unresolved complaints about the carriage of services.

2.13 As at June 2001 membership of the TIO included:

- 54 carriers;
- 909 Internet service providers.[9]

2.14 By April 2004 membership had remained relatively static with:

- 54 carriers; and
- 992 Internet service providers.[10]

2.15 While the number of ISPs is slowly increasing the static number of carriers suggests that open competition at the infrastructure level may be problematic.

Telecommunications competition regulation

2.16 It has been argued that:

> Early in the liberalisation process, there was a widely held view that regulation would be a temporary feature of competitive telecommunications markets. That view now seems overly optimistic. Both international and Australian experiences, coupled with a growing appreciation of the systemic features giving rise to market power in telecommunications markets, suggests that regulatory intervention will be an ongoing requirement for these markets to operate effectively.[11]

2.17 Australian telecommunications is subject to industry-specific regulations anti-competitive conduct. The two key regulatory instruments, within the TPA, aimed at increasing effective competition in telecommunications are:

- A telecommunications-specific access regime (Part XIC) that provides for access to telecommunications infrastructure; and

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9 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16,* September 2001.

10 Telecommunications Industry Ombudsman, website at 7 April 2004, URL: http://www.tio.com.au/Members/Default.htm. The Australian Communications Authority issues carrier licences. By the end of April 2004 it had issued 133 licences of which 105 remained current.

11 David Stewart, Anti-competitive Conduct, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.158.

- telecommunications-specific provisions for controlling anti-competitive conduct (Part XIB), with competition notices and a threshold test, based on 'effect or likely effect'.[12]

The access regime

2.18 The prohibitive entry barriers to facilities-based ownership, principally the high cost of roll-out, force many telecommunications players to rely upon incumbent operators for their initial access to network infrastructure. They are therefore constrained by the upstream conditions and products which are supplied to them by a carrier with whom they are often in direct competition. This environment is not favourable to the development of competitive wholesale and retail services (discussed later in this chapter).

2.19 Part XIC of the TPA was introduced in 1997 to deal with interconnection and access to certain telecommunications services. The term 'access' refers broadly to:

> the ability of carriers and service providers to pass and receive telecommunications traffic over each other's networks, in order to fulfil the imperative that all end-users of similar services be able to connect with one another, irrespective of the particular networks to which they are connected.[13]

2.20 The ACCC administers the telecommunications-specific access regime by 'declaring' key services to bring them under the scope of Part XIC. Once a service is declared, then all providers of that service are subject to 'standard access obligations' (SAOs).[14] SAOs require access providers to supply the access seekers with the necessary interconnection facilities and a level of technical and operational service quality equivalent to that which it would supply itself.

2.21 While declaration initiates SAOs, the regulatory framework emphasises the importance of commercial negotiations in determining the terms and conditions of service supply. The terms and conditions of supply of a declared service can be determined by:

- commercial negotiations, without any involvement from the ACCC
- commercial negotiations, involving procedural directions issued by the ACCC

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12 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16*, September 2001, p.xx.

13 Alasdair Grant & David Howarth, The Access Regime, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.89.

14 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16*, September 2001, p. 219.

- negotiations attended or mediated by the ACCC following a request by both parties
- commercial negotiations, following a good faith direction issued by the ACCC following the creation of an access dispute or during the course of arbitration
- pursuant to an approval access undertaking lodged voluntarily with the ACCC by an access provider
- by arbitration.[15]

2.22 The ACCC has declared 16 services under Division 2 of Part XIC of the Trade Practices Act including:

- Digital Data Access Service
- Conditioned local loop service
- Integrated Service Digital Network Terminating Service
- Integrated Services Digital Network Originating Service
- Local Carriage Service
- Unconditioned local loop service
- Analogue Subscription Television Broadcast Carriage Service
- Line sharing service.[16]

2.23 In June 2000 the Treasurer, the Hon. Peter Costello MP, asked the Productivity Commission to review telecommunications competition regulation in order to examine the effectiveness of current arrangements and assess the policies that would be required as the environment changed.[17] The *Telecommunications Competition Regulation*s inquiry report, released in 2001, made 58 recommendations. The Government introduced a number of reforms to Parts XIB and XIC of the *Trade Practices Act* in response to a number of the report's findings, which were designed to simplify and make more efficient the ACCC's administration of the

15 Alasdair Grant & David Howarth, The Access Regime, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.95.

16 Australian Competition and Consumer Commission, Declared telecommunications services, accessed on 19 March 2004, URL: http://www.accc.gov.au/content/index.phtml/itemId/323824

17 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16*, September 2001, p.xxi.

telecommunications-specific market conduct and access regimes and to facilitate increased competition and investment in the telecommunications industry. These proposed changes were implemented early in 2003 following the passage of the *Telecommunications Competition Act 2002*.[18] The bill had been the subject of inquiry by the Senate's Environment, Communications, Information Technology and the Arts Legislation Committee, which presented its findings on 22 November 2002. The bill was subsequently the subject of amendment by the Senate, which amendments were accepted by the House of Representatives.

Anti-competitive conduct and record-keeping rules

2.24 Part XIB of the TPA, titled *The Telecommunications Industry: Anti-competitive conduct and record-keeping rules,* was developed as a deterrent to anti-competitive conduct and applies specifically to telecommunications markets. Section 151AK of Part XIB states that a carrier or carriage service provider must not engage in anti-competitive conduct. A carrier is deemed to have engaged in anti-competitive conduct if it:

- has a substantial degree of power in a telecommunications market; and;
- either:
    - takes advantage of that power with the effect, or likely effect, of substantially lessening competition in that or any other telecommunications market;
    - takes advantage of the power, and engages in other conduct on one or more occasions, with the combined effect, or likely combined effect, of substantially lessening competition in that or any other telecommunications market; or
    - engages in conduct in contravention of sections 45, 45B, 46, 47, or 48 of the TPA where that conduct relates to a telecommunications market. [19]

2.25 When the ACCC receives evidence of anti-competitive behaviour it initiates an investigation. Once it has deemed that anti-competitive conduct has occurred, or is occurring, it may issue a competition notice in regard to that conduct.

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18 Alasdair Grant & Derek Wilding, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.xi.

19 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16*, September 2001, p.158.

2.26 There are two types of competition notices, Part A and Part B. Part A notices are issued by the ACCC when it has reason to believe that:

- a carrier or carriage service provider has engaged, or is engaged, in an instance of anti-competitive conduct (under section 151AKA(1))
- a carrier or carriage service provider has engaged, or is engaged, in at least one instance of anti-competitive conduct of a kind described in the notice (under section 151AKA (2))

2.27 Part A competition notices are designed to fulfil a 'gatekeeper' role by acting as a obligatory precondition for the bringing of a private action under Part XIB. They are flexible instruments, which at the ACCC's discretion can be revoked or modified in minor ways, without the need for a new investigation. Competition notices issued under section 151AKA (2) do not require the ACCC to specify a particular instance of anti-competitive conduct and this flexibility allows it to investigate where precise evidence has not yet come to light.[20]

2.28 In contrast, under section 151AL, a Part B notice must set out particulars of the alleged contravention:

> A Part B competition notice could therefore be used to consolidate the results of an ACCC investigation into a single document for use by litigants alleging loss or damage resulting from the anti-competitive conduct.
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> Section 151AN provided that a Part B competition notice is prima facie evidence of the matters set out in that notice….The avowed purpose of the Part B competition notice is to facilitate parties taking private legal action to enforce the competition rule or to recover loss or damage arising from anti-competitive conduct.[21]

2.29 While each is a separate notice, in practice a Part B notice is unlikely to be issued unless the alleged anti-competitive conduct has been the subject of a Part A notice.[22]

Tariff-filing directions and record-keeping rules

2.30 Under Part XIB of the TPA the ACCC has been given information gathering powers in order to address issues of information asymmetry. These information gathering powers are:

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20 David Stewart, Anti-competitive Conduct, in *Australian Telecommunications Regulation (3ed.)* Alasdair Grant (ed.), UNSW Press, 2004, p.173.

21 ibid, p.174.

22 Productivity Commission, *Telecommunications Competition Regulation, Inquiry Report No. 16*, September 2001, p.159.

- Tariff filing directions, which require a carrier or carriage service provider with a substantial degree of market power to file certain tariff (price list) information with the ACCC. Additional tariff filing arrangements are imposed on Telstra.

- Record keeping rules that currently require selected carriers (namely, Telstra, Optus and Vodafone) to report quarterly to the ACCC. Record keeping information is used to scrutinise anti-competitive cross-subsidisation by vertically and horizontally integrated companies.

2.31 Under additional measures of the *Telecommunications Competition Act 2002* and in conjunction with the ACCC telecommunication Regulatory Accounting Framework (RAF), Telstra is required to provide accounting separation of its wholesale and retail operations. The objective of accounting separation is to better inform both the regulator and the market of Telstra's costs and revenues (on a current cost basis) and its comparative treatment of its retail business and its wholesale customers.[23]

2.32 Telstra is required to provide reports on a six-monthly and yearly basis to the ACCC. The reports are to contain:

- regulatory accounting records for core services based on *current costs* as well as an historical cost basis;

- an *imputation analysis* comparing Telstra's retail prices with the costs (to competitors) of Telstra's core wholesale services; and

- key performance indicators on *non-price terms and conditions* that compare Telstra's service performance between its retail and wholesale customers.[24]

2.33 In June 2003 the Minister for Communications, Information Technology and the Arts directed the ACCC to implement an enhanced form of accounting separation of Telstra's wholesale and retail accounts. The ministerial direction, issued under Division 6 of Part XIB of the Trade Practices Act, introduced:

- current cost accounting (CCA), as well as the historical costs used in the RAF;

- key performance indicators on non-price terms and conditions that compare service performance between retail and wholesale supplied services; and

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23 Grahame O'Leary, *Enhancing Competition in Telecommunications: Accounting Separation of Telstra's Operations*, Research Note No. 39, Parliamentary Library, March 2004.

24 Ibid.

- imputation analysis (imputation testing) of core telecommunications services supplied to access seekers.[25]

2.34 In December 2003, the ACCC released its initial report relating to accounting separation of Telstra. The report found that on a current cost basis, the aggregate value of assets for the core access services are substantially higher than the historical asset valuations. In proportionate terms, this is particularly apparent for the unconditioned local loop and local carriage services.

2.35 The imputation report is designed to reveal whether there is a sufficient margin between Telstra's retail prices and the prices it charges access seekers to use its network (plus related costs) to enable them to compete in retail telecommunications markets. The results, both on a historical and current cost basis, indicate that Telstra passed the imputation tests for domestic and international long-distance calls and fixed-to-mobile calls, but failed for local call services (line rental and local calls combined). Telstra also passed the test over the bundle for both residential and business customers.

2.36 The third of the reports dealt with key performance indicators (KPIs) for non-price terms and conditions. The KPIs on non-price terms and conditions measured the difference between the percentage of Telstra Wholesale's business and residential customers and Telstra Retail's business and residential customers which met the performance standards (defined in terms of the Customer Service Guarantee measures). This report found that while there was some variance that required further investigation, there was no evidence to suggest that there is any systematic discrimination against Telstra Wholesale's customers.

2.37 In April 2004 the second round of public reports (for the December quarter 2003) for imputation and non-price terms and conditions (NPTCs) in relation to the accounting separation was released by the ACCC. The report concluded similar findings in regard to all areas reported in the December document. In regard to the imputation test, however, it noted that:

> Across these particular indicators, Telstra's second report indicates, consistent with the previous quarter, that there does not appear to be any systematic discrimination against Telstra Wholesale's customers. However it may not be expected to do so given that it is highly aggregated. It does not provide a means of identifying or addressing individual cases of

25 Australian Competition and Consumer Commission, accessed on 8 April 2004, URL: http://www.accc.gov.au/content/index.phtml/itemId/333799

> discrimination. The ACCC will continue to respond to complaints of discrimination on their merits.[26]

2.38 On 30 June 2004 the ACCC issued two reports in relation to the accounting separation of Telstra. The reports covered Telstra's performance in the March quarter 2004. The imputation analysis report which compared Telstra's retail prices with the prices of two core telecommunications access services found that Telstra passed the imputation tests for domestic and international long-distance calls and fixed-to-mobile calls, and failed for local call services (line rental and local calls combined). The ACCC noted that failing the imputation tests in the report was not definitive of competition concerns, and that the fail for local call services may not be of concern due to the common bundling of local call services with other telephony services.

2.39 The second report gave key performance indicators on non-price terms and conditions that compared Telstra's service performance between Telstra's retail and wholesale supplied basic access services. The ACCC found little difference between the results in these reports and those of previous quarters. Additionally, the information provided by Telstra did not reveal any major concerns with how Telstra makes available specific services to access seekers to enable them to compete in retail markets.[27]

2.40 While the reports are intended to provide greater transparency of Telstra's operations to ensure that Telstra does not unfairly discriminate between access seekers using its network services and its own retail operations, a number of weaknesses within the system have been raised with the Committee. These will be discussed in Chapter 3.

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26 Australian Competition and Consumer Commission, Imputation and non-price terms and conditions reports relating to accounting separation of Telstra, December 2003. Accessed on 8 April 2004, URL: http://www.accc.gov.au/content/item.phtml?itemId=494956&nodeId =file40723 82015639&fn=Imputation%20and%20non-price%20terms%20and%20conditions %20reports%20April%202004.pdf

27 Australian Competition and Consumer Commission, Imputation and non-price terms and conditions reports relating to accounting separation of Telstra for the March quarter 2004. Accessed on 30 June 2004, URL: :http://www.accc.gov.au/content/item.phtml?itemId= 520195&nodeId=file40e 204d648578&fn=Imputation%20and%20non-price%20terms% 20and %20conditions% 20report%20for%20March%2004%20quarter%20(June%202004).pdf