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Dr Jacqueline Dewar
Secretary (A/g)
Senate EICTA committee
Parliament House
CANBERRA ACT 2600
4th February 2005

Dear Jacqueline,

Inquiry into the new Australian Communications and Media Authority

ATUG is pleased to make a submission (attached) to the EICTA Committee Inquiry.

The basis of ATUG's submission is our recent submission to the Productivity Commission's review of National Competition Policy where we summarise users concern that competition in telecommunications has not progressed as far or as fast on we would have expected over the 15 years or so since the introduction of limited competition in the from of duopoly. In recent days the OECD's Economic survey of Australia makes the same point – there is further to go in developing competition in telecommunications in Australia.

This is the core concern for ATUG in the proposed "simple" amalgamation of the ABA and ACA "as is" – whatever policy decisions are taken and implemented ought to have as their outcome increased competition in telecommunications, because of the benefits this brings to end users.

ATUG has attached a summary of the UK OFCOM's Strategic Telecommunications Review Phase 2 consultation.

The URL reference below is to the consultation document which contains at Annex J, sections 8 and 11, material relevant to the Committee's Terms of Inquiry and at Annex 0 number of case studies of telecommunications regulation in other countries –
http://www.ofcom.org.uk/codes_guidelines/telecoms/strategic_review_telecoms/?a=87101

OFCOM's review starts with the following comment:

"Telecommunications is an important economic sector in its own right. It also has a growing impact on our lives as individuals, on businesses in terms of efficiency and customer services and on the United Kingdom's competitiveness as a knowledge-based economy."

ATUG would recommend this breadth of vision to the Committee as a relevant context for its deliberations on the Australian Communications Media Authority.

Yours sincerely

Rosemary Sinclair
Managing Director

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ATUG Submission

EICTA Committee
Inquiry into ACMA
January 2005

Introduction

For end users of telecommunications services, the EICTA Committee inquiry into ACMA is very important at a time when new technologies such as wireless (for voice and data), 3G mobile, IP platforms and fibre networks bring the promise of innovation and effective competition and convergence of content and carriage sectors is now occurring.

Over the last seven years of open competition the telecommunications industry has developed from monopoly to duopoly to regulated competition, but has not yet achieved fully effective competition in any market due to the continued bottleneck nature of last mile access.

The access regime of the Trade Practices Act should have provided the first rung of a "ladder of investment". The idea is that companies will use mandated access to build customer bases that will support the subsequent rollout of independent infrastructure, which is the basis of effective competition.

A new debate is developing now about access to content and whether exclusive access will become the next bottleneck. End users are aware the "walled gardens" did not work in the Internet world and were overcome in the Pay TV world with special exemptions from the ACCC at the request of industry. All this experience indicates that end users was open access to content. The role of content as a potential barrier to entry underlies ATUG's concerns about whether proposed role for ACMA goes far enough.

ATUG also notes the developing role for the ACA in regards to content over mobile phones. The ACA current inquiry on new rules for adult content on mobile phones indicates clearly that there is need for coherent regulatory convergence across the previously separate sectors of telecommunications and media.

Experience with Competition in telecommunications

Unhappily over the last 7 years of supposedly open competition, a number of companies who thought they were on this ladder of opportunity found themselves on a ladder of legal process, having to rely on the access and anti-competitive behaviour powers of the ACCC to go to the next rung.

Equity markets have been part of this painful learning experience and for them lessons from investment in telecommunications infrastructure linger longer.

A number of companies have spent significant amounts of capital building independent infrastructure (even ahead of a customer base eg AAPT, Next Gen Networks, IP 1, Comindico, TransAct, PowerTel/Request, UeComm, Hutchison, Macquarie Corporate, Flowcom among others) but have had to rely on arbitration and litigation over many years to achieve real access ie on workable price and non-price terms and conditions. A number have finished up being bought at fire sale prices by larger players.

Even with broadband, a market which was seemingly "born competitive" with an expectation at the outset that market shares would be more widely spread than the usual fixed network services, the ACCC has had to issue competition notices to Telstra to get action, the most recent one of which is still in force.

This short history of telecommunications competition becomes more relevant as debate heats up about how and when Australia will get the wireless, 3G, IP and fibre networks users need to deliver real, not bonsai, broadband and stronger competition in voice services, where margins are still very high.

Australia lost an opportunity in the early nineties to deliver effective competition in last mile access and the benefits this brings to end users, by allowing Telstra to duplicate the Optus HFC rollout. The negative impact of this on Australia's broadband uptake is the subject of continuing comment by the OECD and the ACCC.

As we saw with the HFC cable network - effective infrastructure competition doesn't emerge when different types of infrastructure are commercially converged.

Some commentators are focusing their questions on how to adjust the Trade Practices Act to ensure Telstra has the incentive it needs to build out these new networks. For ATUG, the real question is whether our regulatory framework will encouraging the new entry and innovation users need for an effectively competitive market.

Experience suggests that "tweaking" access regime alone is not enough - effective anti-competitive behaviour provisions are an important part of the story.

Innovation

The end game for telecommunications users is strong and effective competition. New technologies are part of the answer and must be encouraged, not least through the telecommunications regulatory regime. Users are looking for pro-competitive outcomes, not more of the same on a different playing field.

Professor William G Shepherd spoke to the ACCC Annual Conference in 2004 on the effectiveness of regulation. This address is attached. Professor Shepherd reviews US experience on regulating natural monopolies and anti-trust policies since 1900 before coming to the following conclusions:

"..recognise that much more is at stake than mere efficiency. The public interest involves many important goals. Innovation is probably the biggest one.

For over two centuries, innovation has been the great source of rising productivity, progress and welfare. X-efficiency has also been important, and so is the healthy competitive process itself. Also significant are freedom of choice, and fairness in the results, and the sound economic basis for democracy. The regulators' choices need to promote all of these, not just allocative efficiency."

"Fully effective competition.

To be genuinely effective, competition needs to have intense, sustained mutual pressure among competitors, with no monopoly or collusion. For a high probability of good results, the practical basis is:

1. At least 5 'reasonably comparable" rivals. (That number may vary slightly with the situation, but the need for "enough" strong rivals is fully affirmed by literature)
2. None of those firms must hold a dominant position, with 40% of the market or more (ATUG NOTE: the EU uses 25% as an indicator of significant market power)
3. Entry by new competitors must be easy to do."

If our aim is innovation and shared markets, then infrastructure competition is essential. ATUG's support for the Commission's draft recommendation goes to our concern for genuine infrastructure competition - not just between technology platforms but between commercial entities.

OECD Findings on Competing Infrastructure.

The OECD report on Broadband and Telephony over cable television networks (DSTI/ICCP/TISP(2003)1 (attached) outlines the importance of infrastructure competition at page 4,

"…One conclusion that can be drawn from this work is that the broadband markets in one-third of OECD countries are being held back where the cable networks are not providing independent competition with the PSTN. This is evident in the differences in the level of service, pricing and take-up of services. In these cases, all options need to be considered including separating cable networks from incumbent PSTN operators. There may be cases where this is not necessary if these cable networks were developed in an open market (i.e., not under a monopoly or duopoly applying to the telecommunications market."

In regard to broadband the OECD is clear, (pg 19)

"39. The ownership of cable television networks by incumbent telecommunications carriers has had quantifiable impacts on the development of broadband access. The average take-up rate for cable modems on networks owned by telecommunications carriers is just 2.6%. By way of contract the average for independently owned cable networks is 10.7%. In other words, if their home is passed by an independently owned cable company, users are four times more likely to take the cable modem service."

ATUG Research

ATUG's 2002 study into Top 100 buyers of telecommunications services and more recently ATUG's 2004 Regional Broadband Roadshow which visited 22 centres in regional Australia confirm that end users understand the significance of infrastructure competition to the effectiveness of telecommunications markets and to innovation, quality and prices.

ATUG has been supporting competition in telecommunications since 1981, on the basis that a competitive industry would deliver better benefits to end users in terms of prices, service levels and innovation than monopoly providers.

The driver for ATUG's interest has been to ensure that Australian business, government and consumer users are not disadvantaged in comparison to their overseas counterparts in terms of cost structures, productivity and service capability, and innovation.

ATUG believes there are important areas where current arrangements should be strengthened before proceeding with the further privatisation of Telstra.

In the 7 years since open competition, while there has been good progress towards competition, user experience has revealed two major problems in relying on competition alone to deliver public interest outcomes in telecommunications:

1) market power - which has remained an issue even in potentially more competitive geographic markets such as urban areas and still requires significant regulatory attention for certain services and in certain markets eg wholesale broadband offers

2) market failure - which has been an particular issue in non-competitive geographic markets such as regional, rural and remote areas, and will continue to require significant regulatory attention and government funding eg mobile and broadband services in regional Australia

User concerns about market power and market failure need responses in the following areas:

1) The role of Parliament in monitoring the effectiveness of competition in telecommunications and securing public benefit outcomes from this industry
2) The need for continued Government focus and funding in areas that are non-competitive and underserved
3) An ongoing commitment to the role of the ACCC, its telecommunications sector specific powers and its focus on the long-term interests of end users
4) Strengthening the role of the ACCC to include increased powers in regard to wholesale access prices and anti-competitive behaviour,

5) Enhancing the role of the ACA/ABA to one of ensuring pro-competitive outcomes and effective consumer protection

Assessment of competition

Both the ACCC and the ACA provide reports to Government every year in which they assess progress towards effective competition in telecommunications and the reactions of consumers and small business.

The ACCC's Market Indicator Report 2002-2003 reports a picture of continuing dominance across the range of basic services - Telstra has 87% of access revenues; 77% of local call revenues; 71% of domestic long distance revenues; 62% of international long distance revenues; 74% of fixed to mobile revenues.

The ACCC's Annual Reports into Price Changes for Telecommunications Services, 2002-2003, show an unwelcome trend of price increases for some services and some customer groups, during the period of a more relaxed Price Control Regime from 2002. Mobile prices should ring alarm bells given the consistent claim that this is one of the most competitive parts of the industry. The value of the ACCC report is that it goes to past the marketing hype to what end users are actually paying for services.

The ACA's 7th Annual Consumer Satisfaction Survey also makes an important annual assessment of progress in telecommunications competition from the consumer's perspective,

> "As in all previous years, fixed phone line rental was the areas in which respondents were most likely to say the price they paid was too high. Although the proportion of respondents who thought fixed lines prices were too high was slightly lower than in 2003, it still represented the majority of both household respondents and small business customers - 67% and 65%, respectively. This finding was made before the April 2004 announcement that Telstra would be increasing fixed line rental costs."

On satisfaction with competition, the report says at page 29,

"While 69% of household respondents were satisfied with the current level of competition for fixed line services, only 50% were satisfied with the level of price competition for these services. Among small business respondents, 64% indicated satisfaction with the current level of competition for fixed line services, whereas only 54% were satisfied with the level of **price competition** for these services."

The value of competition to all stakeholders in the telecommunications industry is undisputed - the increased availability, use of and spend on telecommunications that accompanies liberalization and innovation is evident around the world. The benefits of this capability to productivity and growth have been well documented by the OECD, Australian government agencies and private sector research companies.

Mobile, wireless, broadband and IP technologies have the potential to take competition in telecommunications to the next stage by allowing cost effective infrastructure and new applications to be deployed in competition with legacy, fixed wire networks.

The question for ATUG is whether ACMA will be able to contribute effectively to achieving pro-competitive outcomes for end users of telecommunications services.

OFCOM's Strategic Review of Telecommunications

"Faced with the technology shift to digital, it is becoming clear that the current market and regulatory structure is unsustainable. It is that challenge that OFCOM's Phase 2 proposals seek to address.

"Telecommunications is an important economic sector in its own right. It also has a growing impact on our lives as individuals, on businesses in terms of efficiency and customer service and on the United Kingdom's competitiveness as a knowledge-based economy….

Conclusion

ATUG contributed to the original DCITA Discussion paper on Options for Structural Reform in Spectrum Management in August 2002, which was the precursor to the combination of the ABA and ACA into ACMA. The then Minister Senator Alston said at the time:

"The current structures for the non-competition regulation of the broadcasting and telecommunications sectors have been in place for nearly a decade. During this time there have been significant changes in the communications environment including: the inception of Pay TV; substantial growth in internet take-up and the use of broadband; the introduction of digital television; and the development of other new services including the impending introduction of third generation mobile phones.

Digital technologies are continuing to facilitate increasingly convergent technological and business environments. There is a need to develop flexible and integrated regulatory structures that can effectively deal with the rapid and sometimes unpredictable nature of these changes while at the same time recognising the central role of broadcasting in meeting Australia's cultural objective."

ATUG believes the policy imperatives have become stronger since the time of this statement and that the powers of ACMA should be enhanced to ensure an effective role for ACMA in achieving pro-competitive outcomes for end users.

Attachment 1

ATUG Opinion this week gives readers a glimpse into the work being undertaken in the UK by OFCOM on its Strategic Review of Telecommunications Phase 2. Many of the same issues face policy makers, industry participants and end user representatives in Australia, but with more urgency as discussion about what needs to be done before T3 becomes more focused.

The following update is provided by David Currie, Chairman and Stephen A Carter, Chief Executive of OFCOM and available on OFCOM's website at:

http://www.ofcom.org.uk/consultations/current/telecoms_p2/?a=87101

"Faced with the technology shift to digital, it is becoming clear that the current market and regulatory structure is unsustainable. It is that challenge that OFCOM's Phase 2 proposals seek to address."

"Telecommunications is an important economic sector in its own right. It also has a growing impact on our lives as individuals, on businesses in terms of efficiency and customer service and on the United Kingdom's competitiveness as a knowledge-based economy.

The telecommunications sector and the communications services we get have been heavily shaped by regulation. In mobile and wireless services, this has been achieved through the allocation of the radio spectrum on which these services depend. That has been a series of regulatory decisions. In fixed line telephony, the 20 year march from a single, state-owned, monopoly towards competitive markets has been enabled - though also sometimes unintentionally diverted - by economic regulation.

The technology behind telecommunications services is at an inflection point. Telecommunications is going from analogue to digital, just as surely as is broadcasting, and probably with even more significant consequences, though they are not as widely recognised or understood. Some of this shift is evident to residential and business consumers, with the growing deployment of broadband, ICT solutions and 3G mobile. Some is less evident, involving the transformation of back office operational support systems and the design of core networks from analogue switched voice, to digital IP-based data. The impact of these changes, on the services we are able to receive and on the economics of the sector will, however, be profound. And while these changes are underway, it will be particularly important to ensure that a safety net of universal service remains available for all.

So Ofcom has undertaken a Strategic Review of the sector with the aim of reassessing the regulatory framework to make it fit-for-purpose against this changing backdrop. In Phase 1 of our Review we posed five questions which the Review would address. These are replicated on the page opposite. We also charted the evolution of regulation and the current state of the market. This Phase 2 Ofcom report builds on that work and sets out our proposals for a future regulatory strategy.

The regulatory framework has developed in three stages since BT Group plc was privatised, as an integrated entity, in 1984. The first stage was based around retail price controls, designed to protect the consumer from monopoly pricing whilst also intended to encourage the company to make increasingly efficient use of assets as nascent competition developed. In the second stage, which followed the last strategic assessment of the sector - the duopoly review in 1991 - the emphasis shifted towards encouraging end-to-end infrastructure competition, with the roll-out of the cable networks. In more recent years, as the limits of end-to-end infrastructure competition were realised and with the emergence in other markets of service-based competition models, the regulatory framework focused increasingly on the provision of access, at the wholesale level, to BT Group plc's network and facilities. And, most recently, the system of detailed market definition and reviews, assessment of significant market power and detailed remedies, created by the series of European Communications Directives, was transposed into UK legislation.

In that 20 year period, the telecommunications sector has delivered for the residential and business consumer. No longer are there waiting lists for residential lines. UK call prices - local, national and international - are amongst the lowest in the world. Mobile telephony has been a success, developing from a standing start in 1985 to over 80% penetration now. The UK today has over 5 million broadband connections, delivered over DSL or cable networks, with five major retail providers. For businesses, the development of VPNs, LANs and WANs has created bespoke data-based options providing both improved service efficiency and significantly lower call costs.

In terms of competitive market structures, mobile is strong with five competing operators and several more virtual network operators. In almost all aspects, the mobile sector displays the hallmarks of a vigorously competitive market. Its evolution will be conditioned more by developments in wireless spectrum use and availability, which we will address separately in our forthcoming Spectrum Framework and Implementation Plan, than by this Telecommunications Review.

The fixed line market, however, remains fragmented. In terms of revenues, market capitalisation and investment, BT Group plc

remains larger than most of its competitors put together. Understandably, fixed infrastructure competition has followed the margin in the system, with competition to BT Group plc (apart from in cabled areas) focused on core and backbone networks. However, the technology shift to IP-based networks requires new investment, to supply what are likely to be products with lower margin than was available in the legacy products and services. There is little appetite for new investment to compete with BT Group plc at the local access level, and in some areas even in backhaul from the Local Exchange to the core network. This is a challenge.

Past regulatory attempts to secure fair access at wholesale level to BT Group plc's networks and facilities have also led to a large and growing range of detailed regulatory interventions, and at times regulatory micro-management of BT Group plc at different points in the value chain, which can set conflicting incentives both for BT Group plc and its competitors and encourage commoditised competition on the basis of regulatory arbitrage.

Faced with the technology shift to digital, it is becoming clear that the current market and regulatory structure is unsustainable. It is that challenge that our Phase 2 proposals seek to address.

This report seeks to address the five key questions that Ofcom posed for the Review. Firstly, in terms of the characteristics of a well functioning competitive market for both residential and business customers, keen prices, wide availability and reliability of basic voice and data services - guaranteed by a choice of suppliers - remain important. But innovation, range and choice in new services are increasingly prized; and the infrastructure that will support them consequently becomes more important. Purely arbitrage-based services are likely to have a limited life-span. The objective is sustainable competition. The increasing choice of new services and tariffs will also put a premium on effective customer information and the ability to switch easily between providers.

Effective and sustainable competition can be achieved in core and backbone networks, provided careful attention is paid to ensuring a successful migration of today's interconnection regime to the very different topography that IP-based networks imply. In local access and other wholesale access products, efficient and sustainable competition is likely to require some continuing regulation to secure genuine equality of access, right through from product design to customer handover. Such regulation needs to be focused on a more limited range of wholesale products than to date - where there are real bottlenecks that are likely to endure. However, where it is focused, it also needs to be more intensive than hitherto. Such

an approach, of much more tightly focused but intensive intervention to guarantee genuine equality of access through key bottlenecks, also creates real scope for a significant withdrawal from sector-specific regulation.

Regulators cannot create investment, nor are they well placed to determine when and how much. That is for the industry and the market. However, the proposals in Ofcom's new regulatory framework will, we believe, encourage investment in scale and reach by BT Group plc's competitors to the deepest possible point of connection with BT Group plc's network. This should ensure that there is an increasing range of services and supply for sustainable competition from last-mile delivery right through to retail services. For BT Group plc's own network investment, Ofcom's framework contains a range of instruments and decisions - such as the review of the Network Charge Control, the valuation of BT Group plc's local loop assets, and the question whether there should be a single weighted cost of capital - to ensure that BT Group plc is able to reap an appropriate rate of return - one which recognises the risks involved in next generation networks.

On the final question posed - whether structural or operational separation of BT Group plc, or full functional equivalence, still remained relevant issues - the answer from the Phase 1 consultation was that, yes, they were still relevant; more so perhaps than we had anticipated. However, the large majority of industry respondents expressed caution about the prolonged uncertainty and disruption to the sector that would be involved in the process which would determinatively answer the structural separation question, namely an Enterprise Act market investigation and subsequent referral to the Competition Commission. If genuine equality of access could be made to work, the overwhelming majority of responses suggested that it would be a far preferable outcome. Equally, however, they shared Ofcom's view that the status quo was unsustainable.

We are at a critical point. There is a genuine opportunity for players in this market, BT Group plc in particular, both to make progress and to benefit the consumer. But market structure and technology development make it a time-limited opportunity. The response of the key players in the market in the coming months will determine whether the sector generally can take advantage of this opportunity, for the benefit of consumers and citizens, and the UK as a whole.

This then is an important consultation. It will run until 3 February. Ofcom will publish the final statement of its regulatory strategy next spring. If responses to the consultation, and market developments between now and then, support and bear out Ofcom's currently preferred course, then a series of specific regulatory - and deregulatory - actions will

follow during 2005. If, on the other hand, we must conclude that a more fundamental examination of the market structure is required, then we will consider making an Enterprise Act reference."

Address to ACCC Conference
Sea World Nara Resort, Gold Coast
Australia
July 29, 2004

ACCESS PRICING, INNOVATION, AND EFFECTIVE COMPETITION

William G. Shepherd

Good things come in threes, and I have three points to discuss. The first is about access pricing; the other two are about the standards for competition that is really effective.

1. Access pricing for an essential facility. A thorny problem; what prices (marginal, average, short-run, long-run, etc.) are best? I'll argue for combining long-run marginal cost with liberal profit limits, backed by aggressive regulation that requires rapid innovation.

2. The standards for effective competition (in the downstream market, or in any market). How can you tell when competition is effective (or "workable") rather than feeble and deficient? I'll urge a simple requirement: at least 5 reasonably comparable rivals, with no market dominance.

3. Deregulation to get effective competition in place of regulation. I'll explain that hasty, reckless deregulation is the great danger. You should keep protective restraints until competition is fully effective (with those 5 comparable rivals).

Always remember that innovation is supremely important. Do your regulation aggressively in compelling innovation, even if you let the firms make some extra profits. And be very strict about effective competition; dominant-firm situations are definitely not good enough.

Those three specific topics may seem pretty hot, but in the U.S. they're long familiar. They reach across the two contrasting policy types: the **regulation of natural monopolies**, and **antitrust policies** to promote competition in "normal" markets. The U.S. divides these two policy types between entirely separate public agencies: **regulatory commissions** who frame controls on costs and prices, and the two **antitrust agencies**

(Antitrust Division and Federal Trade Commission) who only know about competition and monopoly. You're lucky here to have the two types combined in one big, efficient government unit, which -- I hope -- works with seamless internal efficiency to combine the policies beautifully.

I'll briefly review the U.S. history on these issues since 1900 to clarify their current meaning.

A word about me. I've been on the inside for awhile, advising the U.S. Antitrust Division chief in 1967-1968 about some very big cases (such as IBM and automobiles). I've researched the nature of competition and monopoly at great length, and I've written a lot about regulation and antitrust. I've worked and testified on many cases, and for 11 years during 1990-2001 I edited a leading journal on the field, the Review of Industrial Organization.

1. THE PRICING OF ACCESS TO PROMOTE INNOVATION, FAIRNESS AND EFFICIENCY

Access pricing can be simple in theory, but real cases are often very difficult. To focus the discussion, I'll assume that it's clear what precisely the "bottleneck" and/or "essential facility" is. In fact, of course, the nature and boundaries of the essential facility are often quite complicated and contentious in actual cases.

Also, let's assume that costs are crystal clear; especially Long-run and Short-run Costs, and various Average Costs and Average Marginal Costs can be defined and measured accurately. Then the question here is just to choose the right Cost.

The Goals

Also, at the start, recognize that much more is at stake than mere "efficiency." The public interest involves many important goals. Innovation is probably the biggest one.

For over two centuries, innovation has been the great source of rising productivity, progress and welfare. X-efficiency has also been important, and so is the healthy competitive process itself. Also significant are freedom of choice, and fairness in the results, and the sound economic

basis for democracy. The regulators' choices need to promote all of these, not just allocative efficiency.

At the opposite extreme, some neoliberal free-market writers (ranging from George Stigler to Harold Demsetz and Robert Bork -- they are usually known as "Chicago School") say instead that static allocative efficiency is the only goal that economists should talk about. But that claim is clearly too narrow and doctrinaire.

Access Pricing

Two pricing categories need discussion: **1. Marginal Costs** (Short-run or Long-run?), and **2. possibly setting Prices above Average Costs**, so as to give extra profits.

Marginal-Cost Pricing. Downstream firms want to pay only the Short-run Marginal Costs; SRMC is often very low, way below average costs (except during peak-load times). The bottleneck's owner wants to charge a hefty price, at least as high as Long-run Marginal Costs. That will compensate it for all of its real costs of supply in the long run.

As you probably know, there's an impressive literature on marginal-cost pricing, starting well before the 1930s. It has favored the Long-run Marginal Cost standard. Ordinarily, Prices at or above LRMC will be high enough to cover Average Costs too, so the essential-facility firm can stay in business by covering all of its Total Costs with Total Revenues.

Pricing at or above Average Costs. The firm of course prefers to set its Prices even higher, well above the full Average Costs, so as to maximize its profits. The firm will make the claim (just the way drug companies do) that it needs a lot of excess profits in order to make innovations. And with its monopoly of the essential facility, the firm could put the price very high indeed. That's one reason why the ACCC is important; to prevent that over-pricing.

The regulators may be tempted instead to press Price right down to Average Cost, squeezing out every penny of extra profit. That's what perfect competition might do in equilibrium, according to pure theory. Instead of that, the firm will call for looser regulation, to fit "workable competition," and that would usually give higher profits. For example, many industries have some competition, but the leading firms' profits are double or triple the cost of capital (that is, perhaps, above 20% on capital,

year after year). I take it that such loose regulation and high profits are what the "workable competition" point is about. "Workable" means higher than "perfect competition."

"Comparable Returns"?

This point favoring generous profits has some merit; but how generous? One criterion in the U.S. has been "comparable" returns, in light of risks and other factors. If comparable industries usually yield an X% rate of return (15%?, or 20%?), then letting this one earn X% would theoretically fit the efficient allocation of capital. Just the right amount of capital would be "attracted," neither too much nor too little.

But U.S. regulation has been frustrated by the troubles in defining "comparable." Regulators usually hear out the contrasting views of advocates and their experts -- and then they reach a compromise somewhere in the middle. That's sensible, but it's logically very untidy. For Australia, it might just mean putting the permitted "workable competition" profit rate at "some reasonable percent" above the barebones competitive rate. Say, 12-15 percent on capital. The exact percent probably doesn't matter much for efficiency and innovation, as long as it's in the "reasonably generous" range.

Meanwhile, it's crucial for the system to have plenty of physical capacity at all times. By artificially holding back on building its capacity, the firm can deliberately create scarcity. That in turn would justify too-high prices. In the opposite case, super-abundant capacity would call for unsustainable, too-low prices.

Innovation and Progress, Not Just Price-Cost Alignment

Remember that innovation is the most important goal, and price-cost patterns may be much less important. How can regulation promote innovation and progress? My answer involves moderately higher profit incentives, as I've just discussed. That can be done by explicitly allowing a margin of extra profitability. Or there can be "regulatory lag," as the U.S. has done throughout much of the last century. As costs fall, the regulators are slow to squeeze down the prices. Often, that was because hearings were slow and ponderous; often, too, regulators deliberately arranged the lag and made no attempt to recoup high profits.

Australia has this lag, too, in the 5-year limit on changing prices. Maybe it injects strong motives for reducing costs.

But the profits are only passive; they may enable the progress, but they don't apply real pressure actually to make the progress occur. The firm may instead just give the extra profits to its shareholders and avoid doing the innovations. In fact, monopolies and dominant firms are notorious for retarding innovation rather than promoting it. Economic theory is clear about that, and there are many famous examples.

The examples include:
1. AT&T in the 1950s-1970s, stifling innovation in exchange technology, optical fibers, and just about everything else;
2. IBM in the 1960s (as Thomas Watson, Jr., IBM's own chief, openly admitted;
3. Gillette in razor blades (Wilkinson was quicker in stainless steel blades);
4. Eastman Kodak (it excluded rival Berkey from innovations in the 1970s, and Kodak was slow to go into digital after the 1980s); and
5. Microsoft; its quality of technology and software has been mediocre ever since its lucky rise around 1980.

Also, a monopoly or dominant position in the market encourages sloth and self-destruction in the firm. Notorious U.S. examples have been **[also Table 2]** US Steel in the 1910s-1940s, General Motors in the 1950s-1970s, Xerox in the 1970s-1980s, IBM in the 1980s, Boeing Aircraft in the 1980s-1990s, Kodak in the 1990s, etc.

Practical Steps for Regulation

So regulators must mount aggressive, well-informed regulation that requires the actual progress to occur. Most important: the regulators must be aggressive in enforcing rapid innovations. They must know the innovation possibilities thoroughly and be ready to remove the monopoly's favored situation or even allow competition if the innovation is slow. They must also require open policies by the monopoly to guarantee full access by all firms to the chance to innovate and enter. This sort of muscular regulation has been widely discussed in the U.S. (by many experts ranging from Harry Trebing, Bill Melody and Leonard Weiss, to Paul Joskow and Richard Schmalensee) as "performance based regulation."

So incentives under "workable competition" standards must be backed up by the regulators with high knowledge, strict judgments, and strong powers to break monopoly behavior and retardation.

"Price Caps" and "Performance Based Regulation." These two styles have evolved since the 1980s as a way to apply specific profit incentives for progress and efficiency. As you probably know, they involve the regulators in making explicit benchmarks and predictions for future progress and cost reductions. They also choose the "sharing factor" (the % of extra profits which the firm gets to keep) and the time period. Bigger % and longer periods intensify the incentives.

The methods are logically valid, but they require a great amount of judgment about all of the elements. Errors on any part can weaken or nullify the incentives. As with the aggressive enforcement of innovation, the regulators simply have to be on top of everything: technology, costs, the power of incentives, the skill of the firm's managers. This sort of full-strength regulation may require special personal qualities, along with strong backing from the government, and technical skills. The pool of such vigorous talents may include a David Round as well as others in the ACCC.

Other obvious steps are to simplify the hearings and to set ranges rather than detailed, rigid limits. Rely on your own judgment, rather than literal acceptance of the experts or of a theory. Be candid and forceful about efficiency and innovation and overcharges. Don't claim to be following clear logic when in fact you're reaching a compromise among criteria.

Remove the Franchise? Try hard to get the power to remove the franchise quickly if the firm's innovation is slow. Even the threat of removal can have strong energizing effects on a stagnant company. If necessary, hold franchise auctions to permit outsiders to take over. Such franchise bidding was discussed by Harold Demsetz as long ago as 1968 and by others even earlier. Or open up entry while keeping controls on the incumbent, to prevent unfair pricing (see Section 3 below). But remove the restraints only after the full effective-competition criteria are met.

U.S. Baby Bells Access Pricing to "The Last Mile." This leading example has been very complicated and high pressured. Fighting over

several years in regulatory hearings and federal courts, the Baby Bells resisted offering "low" fees. Recently the courts imposed high fees, causing various would-be entrants (AT&T and others) to pull out as competitors. A main problem is that the Baby Bells are both essential-facility suppliers and competitors, so their motives are suspect.

In any event, for aggressive regulation you need leaders who are well-informed, firm and skillful regulators.

2. HOW TO TELL IF DOWNSTREAM COMPETITION IS REALLY EFFECTIVE

Now we change sharply from regulation to antitrust topics, which are about competition and market power. The main lesson is that dominant-firm situations are not acceptable.

The situation of access or any new market often starts with a single dominant company. But dominance is automatically an unacceptable outcome. In general, unregulated monopolies and dominant firms pose serious dangers for innovation and efficiency.

A dominant firm usually has a lot of market power and control; they retard innovation and grow inefficient; it exploits market defects and uses their excess profits to make more defects; it usually abuses market and political processes to keep its dominance for a long time. All the while, it falsely claims to be under pressure and on the ropes, about to be destroyed by its tiny but supposedly deadly little rivals!

It may claim to be in a Schumpeterian process, where the dominant firm generates innovation.

But instead, it's usually just entrenched and stagnant, with no real danger of new entry. And dominant shares decline slowly, at only at 1 point a year or less.

Fully Effective Competition.

To be genuinely effective, competition needs to have intense, sustained mutual pressure among numerous competitors, with no

monopoly or collusion. For a high probability of good results, the practical basis is:

1. At least 5 "reasonably comparable" rivals. (That number may vary slightly with the situation, but the need for "enough" strong rivals is fully affirmed by the literature.)
2. None of those firms must hold a dominant position, with 40% of the market or more.
3. Entry by new competitors must be easy to do.

Market share is the anchor. That fits good economic theory, and it precisely fits what any business chief will tell you. "Competition is about winning in the market, and that means **getting a bigger market share.**" Profit patterns also show that higher market share yields much-higher profitability

Market share's importance is easy to understand, and market share and its effects have been measured. Keep focus; don't splinter into a confusing mass of fragments and theories, including all those in "workable competition."

Market power is the opposite of effective competition: there is just 1 monopolist, or a dominant firm and 2 or 3 little rivals. In the U.S., there are famous examples of companies that hung on to their dominance for half a century or much more.

In contrast to the focus on market shares, the field has developed more and more Criteria Clutter, as follows:

1. The early focus was on dominance in U.S. antitrust cases: Standard Oil, American Tobacco, International Harvester, DuPont, USSteel, AT&T, ... Research and policy emphasized the prevalence of Market Imperfections rather than perfect competition.

2. Then the 1930s were obsessed with oligopoly theory and 4-firm concentration ratios in real industrial markets.

3. In 1940, John Maurice Clark proposed "workable competition," listing some 10 criteria.

But those criteria are obscure and impractical to apply. How can you measure them? And there is no reliable basis for weighting or combining them. So "workable" has little or no objective meaning.
4. In 1956 Joe Bain gave great new emphasis to entry barriers. They are at the edge of the market. That further confused and unfocused the literature for decades. There are a great many barriers sources, and most of them can't be measured, especially the endogenous price-strategy barriers.

5. Then in 1982 the Baumol group proposed the idea of "contestability," trying to displace the fundamental idea of competition entirely.

To escape this morass of confused ideas, we need to focus on Market Share. It's "real," clear and universally known, and it's central to the crucial choices that are made endlessly by real companies. Also, it neatly fits Ockham's Razor, because it's simple and focused. We need to void theory-seminar chatter about many "possibilities" and "factors."

To clinch the point, single-firm dominance is notorious in causing stagnation, ossified rigidity, anti-competitive abuses, and obstruction of change and progress, as I noted earlier.

Define the Markets Carefully and Reliably

Defining markets is the critical first step in measuring market shares. You have to use complex real criteria, as shown in Table 9.

These standards are logically valid, based on wide experience, and practical to apply. A few recent examples include the Oracle company's hostile takeover bid for the PeopleSoft company, telcoms service (land-line, wireless, and Internet), and MGM's merger with Mandalay in Las Vegas, Nevada, USA.
1. An Oracle-PeopleSoft merger: is the market just for large corporate clients, or for all customers?
2. Telcoms: are local and long distance services separate markets, or are they being mingled by the advent of wireless and Internet phone services?
3. An MGM-Mandalay merger: is the market just the leading casinos on the Strip, or does it include all Las Vegas gambling and related businesses?

The U.S. Merger Guidelines methods of 1992 are little help. They starkly illustrate the confusions created by criteria clutter and empty theory. The basic method -- a 5% "Small but Sustained Non-transitory Increase in Price" -- is largely just an empty theory, giving little guidance either to antitrust staff members or to businesses looking for answers.

Moreover there is the weird idea of so-called "uncommitted entrants." If outside firms might come into the market sometime, let's count them as if they're already in the market!

Measuring Actual Dominance and Its Impacts

Market share is the simple, direct indicator of a firm's main influence on the market. Shares over 25-30% usually give significant market power, while those over 40% usually indicate market dominance if other firms' share are much smaller.

Those who focus instead on entry barriers have greatly confused the issues, as quotes from the Merger Guidelines show.

These various factors are nothing but empty seminar chatter, wholly vague and impossible to measure.

Dominance affects only a small minority of the economy. But it's the acute form of market disorder. Dominance is a severe mismatch between a powerful leader and one or several struggling little rivals. New dominant firms regularly seem to arise, often from luck or excellence, or from anti-competitive actions, or from deregulation:
1. Like Standard Oil, Kodak, ALCOA, Xerox, pharmaceuticals, Boeing, Microsoft, with actions to exclude rivals.
2. Also, from the deregulation of monopolies, aggravated by mergers -- Baby Bells, the few western U.S. railroads, electric distribution to final customers, airlines' fortress hubs, ...
3. What's next, in the U.S. and Australia?

Sources of Dominance. Usually dominance arises partly or mainly from **anti-competitive actions**, NOT just superiority or economies of scale. Once dominance is in place, it's reinforced by:
1. exploiting market imperfections;

2. anti-competitive strategic price discrimination (including "Ramsey pricing") in line with market segmenting, that kills off or stifles little competitors;
3. mergers to restore or enlarge high market shares;
4. claims that little rivals are powerful and fatal, that new technology is causing seismic changes, and that new entry is huge and deadly;
5. denials that profits reflect monopoly power or are excessive. They claim instead that high profits reflect only their own superiority, creativity and risk-taking. All of its profits are absolutely necessary, they say, for any future progress to occur.

Instead, progress is usually slowed. The dominant firm usually retards progress. Also, there is bureaucratic slack and slippage.

A Level Field? Like every sport, markets need careful rules for competitive parity and balance. We must set higher, tighter standards, that constrain dominant firms from doing actions that are anti-competitive because of the dominance. When the market-share advantage is 30% points or more:
1. prohibit selective pricing against small rivals,
2. remove product and information controls, and
3. prevent all horizontal mergers

Dominance usually fades slowly, as I noted earlier.
Antitrust actions might reduce the monopoly power more rapidly. That would give high yields in better performance.

3. DEREGULATION: WHEN CAN CONTROLS BE REMOVED SAFELY?

Don't deregulate unless you simply have to. And if you must do it, be very cautious and have no illusions. You'll may well get stuck with an entrenched near-monopolist.

The danger. Deregulation often lets the monopoly become a permanent high-dominance firm, with about 80%, and free of public constraints. It often uses abusive actions in the market and a lot of political actions: price discrimination, controls over information, and controls to block out competition. You will face extreme pressure to accept an 80% dominant firm.

Have no illusions that antitrust can do very much to enforce a shift to effective competition. It can't. It's not a decisive policy to cure monopoly, nor to guarantee good deregulation. Instead, it's usually weak, often outsmarted and stalled; a pretense of control. Its budgets and appointments of leaders are often controlled and limited by those very industrial interests who ought to be under the agencies' control

If you want to shift a dominant firm to effective competition, you will need to act forcefully to achieve sharp changes against severe resistance. Get ready for rough and tough actions, because the monopoly firm will use every device and stratagem to defeat you and keep dominance. Get the national leaders firmly committed to you before you begin. Take bold, maximum legal actions. Be ready to publicize relentlessly the dominant firm's poor innovation, inefficiency, unfair competitive tactics, excess profits, and false rhetoric.

The monopoly will welcome a little competition, to create the illusion of effective competition. But remember that 5 or more comparable rivals are required. A dominant firm is an intolerable outcome.

You will need very good luck: your efforts can be cut off at any point by a loss of political support, by one or several weak judges, or by a powerful publicity blitz.

The Big Danger is Hasty Deregulation

The danger is that deregulation will be hasty and reckless. That would let the monopoly stay a high-dominance firm for decades, with about 80% of the market, often using abusive actions and political actions to get its way. It will use price discrimination against little rivals, controls over information, mergers to stifle competition, and every possible control to block out competition.

So:

1. **Do not accept a dominant firm as the result of deregulation.**
2. **Keep strict restraints in place until the 5+ firms conditions are met.**
3. **Strictly prevent the dominant firm from:**
   a. **selective price-discrimination actions which punish or eliminate specific small rivals,**
   b. **controls on key information, and**
   c. **all horizontal mergers.**

Also, require full information and access for any would-be entrants.

Lessons from Some U.S. Deregulation Cases ---

Airlines: competition was fully effective during 1978-1985, but then mergers and rigid patterns of price discrimination 1985-1988 cut competition especially at "fortress hubs." Such hub dominance should have been prevented by a limit of 35% of hub traffic. Southwest Airlines and other discount airlines have been applying pressure since about 1995. They now have about 25% of all traffic, but some hubs and routes are still not fully competitive.

So careless backsliding almost wrecked deregulation during 1985-88, but luckily the low-cost carriers have been fighting their way in. That may eventually save deregulation, but currently things are still in doubt.

Railroads: The deregulation from 1980 on was pretty effective. Competition was protected by preventing the Southern Pacific-Santa Fe merger 1984, rejecting "contestability" ideas. But weak regulators caved on the Union Pacific-Southern Pacific merger in 1997. Now there are pockets of monopoly faced by a variety of captive shippers.

Telcoms: During 1984-89, AT&T lost market share pretty rapidly in long distance, at 4% per year; because it was constrained against anti-competitive price discrimination. But then the FCC withdrew, and AT&T held its share at 60-65% until 1995. Since then, AT&T then has sunk deeply from its own errors and inefficiency, and from rapid technological change. The Baby Bells still dominate local-exchange markets, and mergers among them have accentuated their market control.

Recently the Baby Bells won a big victory in the Supreme Court, which gives them a freer hand in raising the access charges paid by AT&T, Sprint and other wouldbe local coompetitors. The FCC hopes that wireless telephones and voice-over-Internet-protocol developments will apply enough competition to the Baby Bells. But the Bells are striving to capture those by mergers, and they may also control wireless. Even if cable TV and others rise to face the Baby Bells on an even basis, that's only two main competitors, in total. Remember; that's not enough for effective competition -- either in the U.S. or here, or anywhere.

Electricity: There was a reckless rush during 1995-2000 to deregulate too fast, while tolerating a lot of mergers and secret price-

discrimination sweetheart deals favoring the biggest customers. There was little action to stimulate competition among adjacent distribution utilities. The incredible California-Nevada power crisis of 2000-2001 was a special case of bad deregulation and corrupt manipulation of market prices by Enron and many others. They got away with it, but deregulation has been slowed. Whether it will ever reach fully-effective levels at the distribution level is very much in doubt.

To sum up: deregulation in the U.S. has been far more checkered and marked by bad policies than is usually admitted. We still need aggressive regulatory actions to prevent bad-merger-policy backsliding, and to enforce tight rules against anti-competitive price discrimination by dominant firms. These lessons may apply fully to Australia too.

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