‘yes’ OPTUS

Optus submission to

Australian Senate: Environment, Communications, Information Technology and the Arts References committee

on

The inquiry into the performance of the Australian telecommunications regulatory regime

April 2005

Table of Contents

1. Introduction

1.1 Optus welcomes the opportunity to provide our views to this Senate Inquiry into the performance of the Australian telecommunications regulatory regime. This Inquiry comes at a critical time with respect to the potential sale of Telstra and the need for greater facilities-based competition.

1.2 Optus, as the key full service telecommunications provider in Australia, has a strategy for increasingly extending its presence and activities in metropolitan and regional areas, but the desire and ability to do more is frustrated by the incentives and constraints in the current telecommunications policy environment.

1.3 Optus would like the Inquiry to focus on measures that will improve the outcomes of the competition policy. This will be vital in an environment in which Telstra's ownership leash is removed. Any new regulatory and funding arrangements will need to be carefully structured so that Telstra cannot abuse its new freedoms.

1.4 It is likely that Telstra is on its 'best behaviour' while a full sale is on the agenda in an effort to maximise support for the sale. As a provider that faces Telstra in the market every day, we expect that Telstra will become a more aggressive competitor after privatisation.

1.5 Optus supports competition reform. Fully implementing workable reforms will take some time. It is clear that consumers, industry and investment will need changes that produce outcomes quickly. Optus has, therefore, developed the following key policy changes which when integrated will improve services and prices for people right across Australia, but in particular in rural and regional Australia:

(1) **"Bridge to Broadband"**. Broadband is the key area where policy and regulatory focus is needed. Development of the broadband market has reached a crucial point and Telstra has recently shown its intent to stymie competition in this market. With the right regulatory settings, competitive players like Optus are on the verge of building competitive access networks. But a key impediment is resale interconnect pricing, which acts as a dampener to competitors building their customer base which in turn hampers the speed and scale of possible network builds.

i) Optus proposes reforms to the regulatory framework which would allow the Government and/or the ACCC to offer better interconnect pricing arrangements in return for carriers making infrastructure roll-out commitments.

ii) Promoting competitive broadband infrastructure provides a platform for IP voice and other advanced services, which will provide much needed competition for the local loop.

(2) **Rural and regional policy and funding.** Since 1996, the Coalition Government has spent around $1 billion in grant funds to improve rural

and regional communications. But almost none of this has supported competitive infrastructure. On the contrary, it has largely gone to Telstra, directly or indirectly, serving to reinforce Telstra's dominance in rural and regional Australia. The Government has missed an opportunity to stimulate rural and regional competition and in turn deliver consumer benefits. In addition to the one time funding Telstra has received, every year Telstra gets a cross subsidy of around $60 million from its smaller, less profitable competitors, to subsidise its claimed losses in rural and regional Australia. This is supposedly required to fund Telstra's universal service obligation (USO).

Optus proposes that:

i) Policy settings and funding must shift further to promote competitive infrastructure. Optus has a range of innovative suggestions for programs that would achieve this. Particularly important is fostering a second broadband infrastructure provider in rural and regional Australia. Doing this is a key means of "future proofing" because broadband provides the platform for developing services and applications, which Telstra lacks the incentives to deploy without competition.

ii) The USO as the means of supporting basic services should continue (although it is not appropriate as a vehicle for delivering advanced services). However, Telstra should fund the USO itself; it should no longer receive a cross subsidy from its smaller less profitable competitors. Telstra obtains significant advantage from being the USO provider which means it is highly unlikely that USO services are loss making at all. Further, it is anti-competitive for smaller, less well resourced providers to have to pay a subsidy for Telstra's rural and regional services. This is a significant impediment to rural and regional telecommunications infrastructure investment. Therefore, after 2007/08, (when the subsidy amounts currently being determined by the ACA and the Minister expire), the cross subsidy should end.

(3) **The competition regulatory regime.** There needs to be a further round of regulatory reforms, including giving the ACCC additional tools so it can move more quickly to block Telstra's anti-competitive behaviour.

The specific measures that need to be introduced include

i) A prohibition on Telstra unreasonably discriminating in favour of its own retail operations through the introduction of a non-discrimination rule. This would require Telstra to demonstrate it is not discriminating in the way it treats its competitors and itself where it resells services. This would overcome the significant hurdle of competitors currently having to prove Telstra is discriminating when it behaves anti-competitively.

ii) Measures that prevent Telstra targeting customers it has lost to competitors for 180 days (such measures are in place today in

Canada). This would remove Telstra's ability to use its competitive advantage to undermine competitor's efforts to acquire customers.

1.6 These measures are vital to develop a vibrant competitive environment through infrastructure competition. They will improve services and prices for consumers while also encouraging effective competition that will continue to flourish well after any sale of Telstra.

1.7 Optus' submission is in two parts. The first details Optus' policy proposals in more detail. It explains how the Government can use its policy levers to provide incentives for infrastructure providers to invest beyond traditional urban areas and push competition further into more regional and rural areas that are keen to see the benefits of competition.

1.8 The second part of Optus' submission addresses the Inquiry Terms of Reference. It goes through each area of competition regulation and provides comments and suggestions for changes. Overall, Optus believes that the regulatory process needs to be simplified in order to reduce regulatory risk and wasteful regulatory gaming.

1.9 Again, true effective reform will take time and needs to be in place before Telstra is sold. To implement change that addresses all the shortfalls of the current competition regulatory regime will take some time. Therefore, Optus' suggested policy changes are best implemented as a first-best solution that will achieve competitive outcomes quickly.

2. Optus' policy proposals

Bridge to broadband

Broadband – crucial state of the market

2.1 The Government has a unique window of opportunity. Broadband take up is rising sharply. The market is perfectly positioned to respond rapidly to targeted Government measures to stimulate the roll out of competitive broadband infrastructure – which in turn will drive competition in the local loop. Conversely, if the regulatory settings are not right, Telstra will be able to unfairly make a land grab for customers, and lock out competition.

2.2 The stakes are high. The current environment has similarities to the period in the mid nineties when Telstra was allowed to anti- competitively duplicate Optus' HFC cable. It is imperative this time that the Government act to promote competitive outcomes, and to prevent anti-competitive ones.

2.3 Optus has a specific proposal to the Government to build a "bridge to broadband", which is outlined further below. It involves infrastructure commitments by carriers in return for incentives in the form of better interconnect pricing.

2.4 As part of its election commitment, the Government has announced $50 million to fill in broadband "black spots" in metropolitan areas. The allocation of these funds should be part of an integrated "bridge to broadband" package.

Market on an edge

2.5 Australia has seen a very large increase in broadband take up during the course of 2004. This can largely be attributed to Optus' entry into the DSL market in February 2004, though our resale agreement with Telstra. This caused Telstra – on the eve of Optus' launch - to significantly decrease its own retail broadband prices.

2.6 Telstra's retail price drop, without associated wholesale reductions, was blatantly anti-competitive, in Optus' view. This conduct by Telstra was the subject of a the Competition Notice by the ACCC.

2.7 While this has given Telstra an unfair competitive advantage, Optus is pleased with the ground we have been able to make up. Optus recently announced our 250,000th broadband subscriber. Of these, 50,000 were acquired in just three months. 60,000 of our total broadband base take the DSL re-sale product, and the remainder are connected via our HFC cable. However, as the reach of Optus' HFC cable network is limited (it can only serve about 20% of the households in Australia), DSL provides the principal platform for growth.

Optus poised for major roll out of competitive infrastructure

2.8 Optus is well advanced in considering our own DSL build on a national scale. Building a resale base is key to this. At a certain point, when we acquire a requisite number of resale customers, it becomes economic for us build our own network (through installing equipment in Telstra exchanges). This makes our DSL offering more attractive (through reducing our costs and increasing the areas we can viably serve). Just as importantly, we can provide voice over DSL. This will make Optus a much more potent competitor against Telstra in the local loop, as we will have both voice and data services to match Telstra, and our economics will be much more attractive to them today, when we use low margin resale service to compete. In short, a competitive DSL large-scale network – which Optus is in the best position to provide – is the key means of overcoming Telstra's local loop dominance.

Building a resale base is key to launching facilities based competition

2.9 The speed and scale of Optus' DSL build critically depends on Optus' ability to build our resale customer base, and to transition that base to a facilities based DSL service running over unconditional local loop (ULL). The key problem that Optus faces is that we are very much retarded in generating growth by the poor economics in providing consumer resale services – particularly the local call resale (LCR) service.

2.10 The problem with the economics for Optus begins with the fact that the ACCC deliberately makes resale services unattractive. It does this because it wants to encourage infrastructure competition. This is a worthwhile aim, but the flaw in the approach is that it fails to recognise, as described above, that building the resale base is key to the transition to competition at the infrastructure level.

2.11 Optus' argument in this respect is supported by our prior actions. When Optus entered the mobile market, we initially competed by reselling Telstra's analogue AMPS mobile phone service. We grew our customer base which allowed us, at a certain point, to build our own digital GSM network, and to transition our customers to that network. Today we see the competitive benefits that have been generated in the mobile telecommunications market - which is far and away the most competitive component of the telecommunications sector.

2.12 The price set by the ACCC for LCR (currently 13.61 cents), is such that the service in isolation is loss-making. Of course, local calls are not sold in isolation, but bundled with long distance and international services. However, even in such bundles the service makes an inadequate margin. As rebalancing occurs, these margins will erode further.

2.13 The approach to LCR interconnect pricing thus creates a vicious circle that hampers the deployment of infrastructure. Such infrastructure is in turn key to facilitate desired policy outcomes of scale competitor(s) for local loop and broadband services, lower prices, faster broadband take-up, and more innovation.

The Bridge to Broadband Proposal: What Optus would commit, and how Government could secure this commitment

2.14 The essence of the "bridge to broadband" proposal is that competitive carriers and service providers are given a more a favorable LCR interconnect rate in return for making commitments in relation to a large scale DSL build. This would be for a build that is of a greater scale and is rolled out more quickly than would be feasible for Optus under current scenarios.

2.15 The approach advocated by Optus seeks to reverse the vicious circle mentioned above. It suggests a regulatory approach that is more outcomes focused in that it will specifically ensure competitive networks.

2.16 Optus considers that the LCR per call wholesale price should set at 10 cents and the monthly line rental should be set at $25. In return, Optus would enter into a Network Development Deed making specific DSL build commitments. If Optus failed to meet the build requirements in the Network Development Deed, this would be penalized by means of a return to regulated rates.

2.17 This approach only requires the mandated lower LCR rate to be in place for a limited period of time. Once Optus has built its DSL network, our reliance on LCR would be greatly reduced, as we would only use it in areas where a DSL build was not economic.

$50 million broadband commitment for metropolitan "blackspots"

2.18 The Government's emphasis on rural and regional areas has created an imbalance given the lack of support of "blackspots" in metropolitan areas. It is pleasing that the Government is seeking to redress these blackspots with its election commitment of $50 million.

2.19 This money should not be used to fund Telstra to install DSL equipment in Telstra exchanges that do not presently have such equipment. To do so, will fund Telstra for works which are, or should clearly be, within its forward work plans. To make the funds available to Telstra would provide another example of Government funding reinforcing Telstra's competitive advantage.

2.20 In Optus' view, these funds should be isolated for competitive providers. Such an approach would encourage new competitive technologies such as wireless broadband.

2.21 As part of the process for allocation of this funding, it will be necessary that information be provided (in most cases by Telstra) to identify the location of blackspots.

Rural and regional funding

2.22 Optus is in a prime position to provide insight into the commercial delivery of competitive telecommunications in rural and regional Australia. Over our 13 years in operation we have steadily increased delivery of networks and services into rural, regional and remote Australia on a commercial basis. These include GSM mobile, dial up internet, trunk network capacity and a range of satellite delivered services. Part 5 of this document contains further information about Optus and in particular its activities in rural and regional Australia.

2.23 Optus is also uniquely placed to provide comment on Government policy and funding initiatives designed to improve the telecommunications environment. Optus has sought to access various of the funding components, and been directly affected – in positive and negative ways – by most of the policy measures directed toward rural and regional telecommunications.

2.24 In relation to funding, the key issue for the future is to design funding initiatives that promote competitive infrastructure, rather than operate to entrench the position of the incumbent.

2.25 The other key area for Government reform relates to the funding mechanism of the Universal Service Obligation (USO), under which Optus and other non-incumbent telcos must pay an annual $60 million plus cross subsidy to their largest competitor, and dominant player, Telstra. Given the state of the market, this cross subsidy is absurd. While the USO should continue to guarantee the provision of basic services, the cost should be borne by Telstra, as recently recommended by the Department of Communications following a comprehensive review.

Competitive delivery of services in rural and regional Australia, and the need to promote new technologies

2.26 The 2002 Report of the Regional Telecommunications Inquiry ("Estens Inquiry") concluded as follows:

"The inquiry noted and supports the view....that promoting open, fair and unfettered competitive opportunities is the best way to achieve improved levels of service, access to new technologies, consumer choice and downward pressure on prices in regional, rural and remote Australia.

"At the same time there are always likely to be areas where competition is not fully effective, and where Government intervention is necessary to achieve more equitable outcomes for consumers. Such Government intervention, to the maximum extent possible, should also seek to promote vigorous competition among telecommunication services providers."

2.27 Above all, funding and policy measures must be developed in line with this statement.

2.28 There are particular challenges for new entrants in delivering services into rural and regional Australia. The less densely populated an area is, the more it costs per customer to build a telecommunications network. The problem is then compounded by the fact that a new entrant begins with zero percent market share, competing against the 100% enjoyed by Telstra as the legacy incumbent. Moreover, Telstra has an existing network, so it does not face the cost challenges of building a new network.

2.29 For all these reasons, Telstra has been relatively protected from competition in rural and regional Australia. As a direct consequence, in many places Telstra's network is not as modern and efficient as it could be.

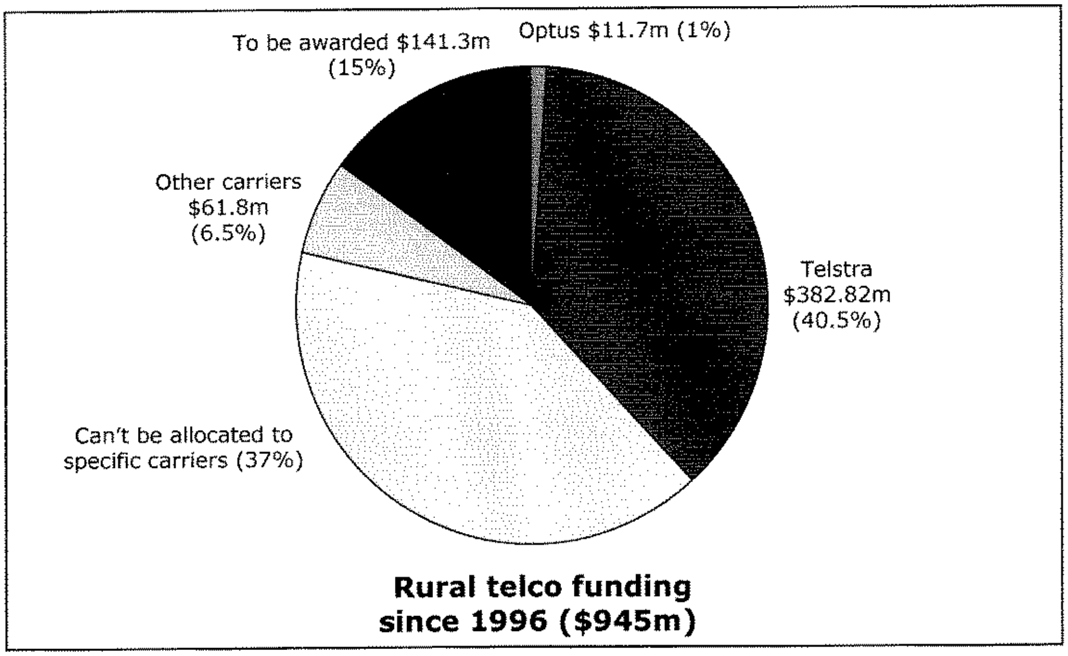
2.30 It is important to create incentives for new technology to be introduced in rural and regional telecommunications or else people in rural and regional Australia will increasingly receive an unsatisfactory level of service.

2.31 Competition provides that incentive. New operators like Optus introduce the latest equipment and services. In turn, the incumbent upgrades its network to ensure it is not left behind.

The traps to avoid

2.32 Optus does not wish to highlight the flaws in past funding and policy initiatives for its own sake, and Optus acknowledges the Government's willingness to listen to Optus' concerns and to adjust more recent initiatives accordingly. Nevertheless, some competitive problems continue with more recent arrangements, and the problems of the past need to be understood to ensure that they are not replicated in the future.

2.33 At the heart of the problem is the fact that very little of the approximately $1 billion that the Government has allocated to rural and regional communications services has actually gone to support the development of competitive infrastructure. This is illustrated by the graph below showing the allocation of $945 million of Government funding for rural telecommunications since 1996. Over 40% of the funds have been used directly by Telstra. In addition, it is fair to assume that the a large bulk of the $347 million not attributable to specific carriers indirectly supported Telstra infrastructure and services. On the other hand funding directed toward non-Telstra carrier constitutes only 7.5% of the funds.



2.34 To a large extent, therefore, that funding has serviced to bolster the rural and regional dominance of Telstra, and some initiatives have had a serious anti-competitive effect.

2.35 Competition concerns with funding initiatives include the following:

- The failure of the $700 million Networking-the-Nation fund to deliver optimal outcomes. Its piecemeal applications meant projects were almost always delivered using Telstra's infrastructure, and competition was not promoted.

- The failure to allocate $150 million to provide untimed local calls in extended zones to a new entrant missed a once-in-a-generation opportunity to provide a platform for competition in rural and regional Australia.

- The acceptance by the Government of a free offer by Telstra of broadband satellite equipment to residents in the Extended Zones foreclosed competition in satellite broadband services in those areas, with medium to long term detriment to consumers.

- 85% of the approximate $165 million allocated by the Coalition Government to mobile services has supported Telstra, and its CDMA network[1]. This has benefited the less than one million Australian who use Telstra's CDMA network, as the expense of the approximate 16 million Australians who use GSM networks. It has also created competitive inequities between Telstra and other mobile operators.

- Serious questions of process have arisen in a number of tenders to award mobile funds. Optus' most serious concern relates to the tender to provide coverage in towns of over 500. Under the terms of the tender, roaming was required to be provided for GSM base stations funded under the tender. Telstra was the successful tenderer yet refuses to offer roaming, with the Government declining to intervene. This denies the benefit of the funding to customers of non-Telstra GSM networks.

- The impact of new entrants having to pay an annual cross subsidy of around $60 million to support Telstra's rural and regional basic services under the USO (this issue is elaborated below).

2.36 More recently, Optus is pleased that the Government has given greater thought to funding mechanisms that endeavour to promote competitive outcomes:

- The National Communications Fund (NCF) following Besley, and the Cooperative Communications Infrastructure Fund (CCIF), following Estens, are similar programs which have been somewhat more conducive to delivering competitive outcomes. The programs have supported a limited number of reasonably large scale projects, and have encouraged partnerships (and funding contributions) between carriers, state and territory governments, and others. Optus is pleased to have lodged the number one ranked bid under NCF. In partnership with the NSW and NT Governments, Optus is providing interactive distance learning to school of the air and isolated students by satellite in a $17 million project. Nevertheless, it is still the case that under the NCF, the majority of the funding has gone to support Telstra infrastructure.

- A stated key element of the Higher Bandwidth Incentive Scheme (HIBIS), is to encourage competitive supply of broadband services in rural and regional Australia. To facilitate that objective, the Government has appropriately limited Telstra's access to the funding to no more than 60%. Still, the requirement that Telstra's ISDN availability delineate levels of funding gives Telstra very significant advantages.

Principles to guide future funding

2.37 Based on our experience of the past, there are some key points that Optus wishes to highlight, to guide policy in the future:

- The need for Government to be acutely aware of the competitive outcomes of its funding and policy measures.

[1] The one exception was $25 million being awarded to Vodafone for highway mobile coverage

- The past lack of regard in a number of programs as to the competitive consequences, which has entrenched the incumbent's position.

- That to overcome the legacy of Telstra's monopoly, the Government must take special measures and practice positive discrimination to promote the competitive environment.

- A "leg-up" to competition will deliver in the medium to long-term the benefits that competition brings. As competition develops the need for Government support will be eliminated or reduced.

- More recent programs have been more "competition conscious", but further improvement is still needed.

- The USO funding arrangements, under which new entrants have to pay Telstra to deliver basic rural and regional services, acts a serious impediment to improving rural and regional services (see further below).

Universal Service Obligation

2.38 Optus supports the fundamentals of the USO in telecommunications.

2.39 All Australians, regardless of where they live, must continue to be entitled to receive the standard telephone service on an equitable basis and within specified time frames. This is guaranteed under the USO. What Optus believes must change, however, is how the USO is costed and paid for.

2.40 A recent comprehensive review of the USO by the Department of Communications, Information Technology and the Arts recommended that Telstra should absorb the cost of the USO. Optus supports this recommendation.

2.41 Telstra is the USO provider. This requires it to provide the standard telephone service at specified prices and within specified time frames to all Australians, regardless of where they live. Other carriers such as Optus are required to contribute to the cost of the USO. The amount other carriers pay to Telstra is determined as a proportion of their revenue compared to industry revenues.

2.42 The Minister, following analysis by the Australian Communications Authority, determines the amount of the USO. In 2002-03 it was set at $234 million. Other carriers contributed $67 million of that amount to Telstra. Optus' contribution was around $40 million.

2.43 This $67 million cross subsidy entrenches Telstra's incumbency advantages and stifles competition. If competition is to flourish in rural and regional Australia, the cross subsidy must be stopped.

2.44 The Estens Inquiry agreed with industry submissions that the USO acts as an impediment to the development of competition in regional Australia, and this was endorsed by the subsequent inquiry by the Department of Communications, Information Technology and the Arts referred to above.

2.45 The current USO funding arrangements have a detrimental effect on the provision of competitive services in rural and regional Australia for the following reasons:

- In an environment where competitive carriers are struggling to make inroads against the continuing massive dominance of the incumbent, the USO regime actually requires competitive carriers to cross-subsidise Telstra's activities, and thus strengthen Telstra's position.

- The USO contribution acts as a significant disincentive for competitive carriers to provide their own regional and rural services.

- The contribution of other carriers to Telstra bolsters the significant brand and marketing value Telstra obtains from being the national carrier, and from having a ubiquitous service.

- The arrangement entrenches outdated technology. Telstra can get away with band-aiding its outmoded networks, and has little incentive to invest in the latest technologies.

- Rural and regional consumers do not know that under the current USO laws, the industry as a whole contributes to the provision of their standard telecommunications services. This creates an incorrect perception amongst regional and rural consumers that they have Telstra alone to thank for their rural services, in turn cementing their loyalty to the incumbent, and making change less likely.

2.46 The 'pure' economic policy analysis points clearly to one result: Telstra should bear the full cost of the USO itself. This is so for several interrelated reasons.

2.47 Firstly, when properly costed, it is unlikely that the USO in fact causes Telstra any significant loss at all. The current costing and allocation approach is fundamentally flawed:

- The process significantly understates the revenues that Telstra derives from USO services.

- There is no recognition of the 'intangible benefits' that Telstra receives from being the USO provider. Two recent analyses, one by a Government commissioned consultant, and the other by an Optus commissioned consultant, put this benefit at between $70 million and $136 million.

- In many other countries, the incumbent bears the full cost of the USO. In the UK, for instance, British Telecom provides USO services without compensation, because the regulator has found the intangible benefits are greater than the actual USO costs.

- In a range of other countries, competitive and structural issues have been considered in arrangements where the incumbent absorbs the USO cost; for instance Spain, Portugal, Denmark, Luxembourg, Switzerland, Sweden, Norway, and the Netherlands.

- The Nordic countries provide a particularly interesting comparison. They face challenges in the delivery of ubiquitous telecommunications services similar to those we face in Australia: large geographic land masses; dispersed populations; and extreme climatic conditions. In all of these countries, they incumbent bears the cost of the USO in full.

2.48 In light of the above, as a precondition to the further sale of Telstra, the Government must implement arrangements whereby over time Telstra should fully absorb the cost of the USO. In Optus' view, Telstra should absorb the cost after 2007/08. This is at the conclusion of the period for which USO costs are currently being considered by the ACA and the Minister.

2.49 The impact on Telstra at this point would be that it would no longer receive an annual cash subsidy from the rest of the industry. However, based on recent determinations by the ACA, by 2007-8 the amount of the cash subsidy – and thus the impact to Telstra – will have reduced.

2.50 The ACA has recently released its draft view of the USO costs for the next three years (which amounts will ultimately be determined by the Minister). The draft amount decreases substantially each year, and in 2007/08 is recommended as $145 million (compared to $234 million in 2002/03). Based on existing industry revenues, the industry contribution at that point would be in the order of $40 million. The actual impact after tax and compliance costs would be around $25 million. This is less than 0.15 percent of Telstra's revenues and about twice Telstra's annual entertainment expenses. The detriment to Telstra would be trivial; but the boost to competition would be significant.

Expanding the scope of services delivered under the USO

2.51 Optus concurs with finding of the Estens inquiry that:

> "The Universal Service Obligation is not an effective mechanism for providing broad consumer access to an increased range of services into the future. There are a range of other more appropriate policy options available to the Government to achieve equity objectives in the future."

2.52 Clearly, subsequent initiatives such as the Higher Bandwidth Incentive Scheme (HiBIS) and Cooperative Communications Infrastructure Fund (CCIF), are examples of more appropriate policy options.

2.53 Optus' suggestions for ongoing initiatives are discussed in further detail below.

Optus' suggestions for future funding programs and initiatives

2.54 **Funding for competitive broadband** In broad terms, funding should be directed to support competitive broadband platforms (DSL, wireless and satellite) though a variety of initiatives, including extending or adapting a number of current initiatives.

2.55 DSL build involves a carrier placing their own equipment in Telstra exchanges. This vastly improves the economics of broadband DSL, compared to reselling Telstra DSL services. Wireless, or wireless local loop, (WLL), involves the construction of base stations in regional towns which provide the local access via wireless, with the trunk networks either terrestrial, satellite or wireless.

2.56 These broadband networks provide a platform for voice over IP and other advanced services such as video on demand. This in turn provides a means of overcoming Telstra's local loop dominance. Without infrastructure competition for broadband, Telstra will have little incentive to offer these value added services, which will cannibalise its existing customer base. However, a competitive provider will have an incentive to offer the full range of services, which will force Telstra to do the same. As broadband networks provide the platform for the future delivery of services, introducing incentives to build competitive broadband infrastructure would be a powerful measure to "future proof" rural and regional Australia.

2.57 In addition, expanding competition in broadband networks in rural and regional areas will make the broadband market as a whole more competitive, which will make broadband more affordable for all Australians.

2.58 **Telstra excluded from further funding** Optus considers that in future funding arrangements Telstra should not be eligible to access Government funding, for all the reasons outlined above. Support needs to be focused on delivering competitive infrastructure. Telstra's continuing dominance and the fact it has been the prime beneficiary from most of the past funding, means that it should be excluded for the future. All the suggestions below should be read on the basis that Telstra should not be eligible to apply for any of this funding.

2.59 **HiBIS** Optus considers that the HIBIS model in broad terms has been an appropriate vehicle to facilitate affordable broadband in rural and regional Australia. All Australians now have reasonable access to broadband services at around the same price whether by DSL, satellite or wireless. Optus believes these should be a continuation of HIBIS, and the allocation of further funding – should demand be evident.

2.60 **CCIF/NCF** Both the National Communications Fund (NCF) and the Cooperative Communications Infrastructure Fund (CCIF) should be models that are adopted for future funding to promote broadband services in health, education and other sectors, for the reasons advanced earlier.

2.61 **Sales channels** A key hurdle for new entrants in delivering services in rural and regional Australia is the challenge of establishing distribution channels across a vast and sparsely populated country. In contrast, Telstra as a monopoly has had decades to build its own extensive rural and regional presence.

2.62 Optus believes that the Government should consider measures to support new entrant sales channels. There is a real opportunity for Government to support the delivery of competitive key services as part of its broader service delivery reforms. Government service delivery agencies have recently been amalgamated under the new Department of Human Services. In relation to rural and regional service delivery, consideration should be given as part of these reforms (which may well include co-location of key services) to providing shop fronts and/or kiosk space for the sales of essential competitive services, such as telecommunications.

2.63 This would provide a convenient and relatively inexpensive means of encouraging a wider geographic spread of sales outlets in rural, regional and remote Australia, and overcome the inherent Telstra advantage.

2.64 A similar approach could be applied in relation of government funded Rural Transaction Centres.

2.65 **Broadband awareness** A key issue for rural and regional Australia is lack of awareness of broadband and the benefits that it brings. While past and current government initiatives have sought to address this to an extent, more can be done. The Australian Telecommunications Users Group (ATUG) has recently conducted a series of broadband "roadshows" in regional towns around the country, and this has been a very effective means of promoting broadband to small business and the community. The Government should fund future similar initiatives.

The competition regulatory regime

2.66 The core elements of the telecommunications competition regulatory regime are contained in the Trade Practices Act (TPA), and are administered by the ACCC. There are two essential components. The first is the access and pricing regime, which provides detailed and complex procedures which allow Optus and other non-incumbent telcos to access Telstra's monopoly networks and services.

2.67 The second component is the telecommunications specific provisions that provide for actions to be taken against anticompetitive conduct. These components provide the foundation on which the competitive environment is built.

2.68 Both components have been the subject of rolling reforms since they were introduced, with the most recent reforms passed in 2002, to establish an accounting separation regime.

2.69 There is a clear need for a further round of reforms, and it is imperative that this happens in advance of the full sale of Telstra, when it is likely that Telstra will behave in an even more aggressive way than it does today.

Operational separation

2.70 There is ongoing debate concerning the separation of Telstra. At the heart of this debate is the concern that Telstra will continue to have strong incentives to favour its own retail operations at the expense of competitors who are wholesale customers. These incentives are very difficult to detect or curtail. Optus is well aware of, and experiences on a daily basis, Telstra's behaviour in this respect.

2.71 The accounting separation regime that was introduced in 2002 required greater disclosure by Telstra of its costings and internal pricing. This was designed to make it easier for both the ACCC and Telstra's competitors to determine if Telstra was favouring its own retail operations.

2.72 The result has been disappointing, a fact recognised by both the industry and the ACCC. The information being provided is far too disaggregated to be used in any meaningful way, and the ACCC has indicated that there is little potential for improvement.

2.73 The failure of the accounting separation arrangements has lead to a focus on other measures. The most extreme of these would be structural separation options. These might involve breaking Telstra into separate retail and wholesale/network entities which were under separate ownership. This would be a break up nearly as dramatic in the Australian content as the break up which the US Government imposed in the early eighties on the then US dominant telco, AT&T. That company was split into a long distance company and seven local telephony companies, each under separate ownership.

2.74 The Government has consistently rejected structural separation as an option. In view of the Government's strong opposition to structural separation of this kind, Optus sees little point in making the case for such a reform.

2.75 Debate is now turning to other options, short of structural separation, that go to remove Telstra's incentives to favour its own retail arm. The fundamental problem today is that Telstra's competitors are not able to purchase Telstra's services for resale in a way which lets them compete effectively with Telstra. Telstra is able to favour itself in myriad ways – price, quality of service, speed of installation, speed of repair and so on.

2.76 A significant factor which assists Telstra to disguise the favourable treatment it gives itself is that Telstra sells vertically integrated services in the retail market. These are difficult to compare with the services Telstra's competitors offer – made up as they are of a Telstra wholesale product plus the retail services (billing, customer service etc) which the competitor adds on top.

2.77 Generally, Telstra presents a wholesale version and a retail version of each product. The wholesale product is not used by Telstra's retail division. This approach, which is unlikely to be accidental, makes any direct comparison of Telstra Retail, and its non Telstra competitors, extremely difficult.

2.78 The potential for reform has been outlined by the ACCC's Telecommunications Commissioner Ed Willett:

"[Reform] would require further changes to Telstra's organisational structure, in addition to accounting separation arrangements. For example, a clearer separation of Telstra's wholesale and retail businesses would enable the costs and revenues associated with each business (as well as transfers between them) to be identified and allocated more clearly.

"The integrity of this approach could be further reinforced by requiring the discrete businesses to maintain separate management teams in different physical locations, with restrictions on the information that can be transferred between them." (Speech, AFR Telecom Summit, "Gaining a Competitive Edge in the Telecom Sector" 15/11/04)

2.79 The ACCC's thinking in this respect is consistent with that of the UK regulator OFCOM. In November 2004 OFCOM released its "Strategic Review Telecommunications Phase 2 Consultation Document".

2.80 The Document comes to the initial view that consideration of structural separation of British Telecom (BT) is premature, but that the issue of equality of access needs to be tackled "head-on". Equivalence of access refers to the same or similar regulated wholesale products, at the same price and using the same or similar processes.

2.81 Creating equivalence requires both organisational and behavioural change. In OFCOM's view it requires:

- "Significant shift in [the incumbent's] behaviour at an organisational level in support of equivalence at the product level
- "Changes in management structures, incentives and business processes, which today remain as a consequence of [the incumbent's] historic structure as a vertically-integrated operator
- "Information flows within [the incumbent] which mirror the information flows between [the incumbent] and its wholesale customers, so that its customers are able to influence [the incumbent] to the same extent that different parts of [the incumbent] can influence each other
- "That this level of equivalence within the organisation can be demonstrated through transparency" (p15)

2.82 In the Australian context Optus endorses an examination of further changes within Telstra to assist in delivering equivalency. However, we indicate this support together with a note of caution and a qualification.

2.83 In assessing the imposition of any new regulatory requirement, it is necessary to assess the benefits to be achieved against the cost in implementing the requirement. That test has not been met in the case of accounting separation. The costs in that case have not just been borne by Telstra but by other carriers who are required to provide detailed data to the ACCC.

2.84 A key impediment in accounting separation has been that the complexity of Telstra's operations have made it too difficult for the ACCC to penetrate its accounts in any meaningful way. While operational separation options may have a theoretical attraction, there is a considerable danger is that the same barrier will be encountered; namely, Telstra will resist change and the regulator will be unable to gain sufficient insight to force organisational and behavioural requirements to deliver tangible outcomes. The end result could be significant effort and cost for no net gain.

2.85 Optus provides comments below in response to the Terms of Reference about recent proposals about the operational separation of the wholesale arm of Telstra from its retail arm.

2.86 While reform in this area should continue to be examined, these concerns should be front-of-mind as final decisions are taken. In addition, given the uncertainty of outcome in this area, Optus believes that Government should give greater weight to reforms which have clearer and more direct outcomes. In this respect, the Bridge to Broadband proposal outlined previously promises much more immediate and certain benefits.

2.87 Finally, Optus is concerned to ensure that any structural separation measures are strictly targeted to where the harm exists , namely Telstra and its fixed line network. Any legislative requirements should impact only on Telstra and, to that end, the requirements should be placed in the Telstra Act, not in the Trade Practices Act.

2.88 In advance of considering broader organisational reforms, there are two incremental and immediate reforms that Optus believes should be introduced to curb Telstra's discriminatory and anti-competitive behaviour.

2.89 The first is to create a direct remedy in relation to discriminatory conduct, and the second is to seek to prevent anti-competitive attempts to "win back" customers. These are outlined in detail below.

Anti-discrimination provision

2.90 The current regulatory arrangements do not adequately address the issue of preferential dealings, i.e. that Telstra can provide services to itself at price below those charged to access seekers, or on terms and conditions less favourable to those provided to itself.

2.91 Attention should be focused on the development of specific non-discrimination rule (NDR) about price. A properly constructed NDR will ensure that Telstra (whether network, wholesale or retail) has to supply services to competing firms at comparable prices, and on similar terms and conditions, at which those services are supplied to Telstra's internal divisions.

2.92 This NDR could be cast as a prohibition against "unreasonable" discrimination between carriage service providers or the end-users of any carriage service provider in the provision of listed carriage services. The ACCC should be empowered to determine whether discrimination is unreasonable, having regard to all the relevant circumstances.

2.93 By way of comparison non discrimination provisions are found in Singapore, the UK and in EU directives.

2.94 A non-discrimination rule will be more effective and achieve greater competition benefits than relying on the existing TPA provisions, which set high thresholds for the ACCC to take action. Under the existing provisions, it must be proven that Telstra has acted in a discriminatory manner and that such behaviour will or is likely to lead to a significant lessening of competition. Moreover, a non-discrimination clause will speed up the processes of competition at the wholesale level by placing the burden on Telstra to act properly, rather than others (including the ACCC) having to "catch Telstra out".

Measures to overcome Telstra's unfair ability to win back customers

2.95 Telstra's vast resources allow it to aggressively win back customers from smaller competing carriers and internet services providers. This problem is exacerbated by Telstra's slow and cumbersome wholesale service. For example, the timeframes mean that it takes longer for Optus to order and provision a local call resale service from Telstra Wholesale, than it does for Telstra Wholesale to notify Telstra Retail that the customer is leaving Telstra – which then allows Telstra to seek to win the customer back.

2.96 This issue has been recognised by governments and regulators around he world as an impediment to long-term competition. The Canadian regulator has imposed a restriction on incumbent carriers preventing them from attempting to win back subscribers for a period of 180 days after the subscriber's service has been completely transferred to another local service provider. This restriction was enforced recently against Bell Canada.

2.97 Optus recommends a measure of this kind as a vital short to medium policy measure to shake-up Telstra's dominance.

3. Addressing the terms of reference

(1) Whether the current telecommunications regulatory regime promotes competition, encourages investment in the sector and protects consumers to the fullest extent practicable, with particular reference to:

i) whether Part XIB of the Trade Practices Act 1974 deals effectively with instances of the abuse of market power by participants in the Australian Telecommunications sector, and, if not, the implications of any inadequacy for participants, consumers and the competitive process;

ii) whether Part XIC of the Trade Practices Act 1974 allows access providers to receive a sufficient return on investment and access seekers to obtain commercially viable access to declared services in practice, and whether there are any flaws in the operation of this regime;

iii) whether there are any structural issues in the Australian telecommunications sector inhibiting the effectiveness of the current regulatory regime;

iv) whether consumer protection safeguards in the current regime provide effective and comprehensive protection for users of services;

v) whether regulators of the Australian telecommunications sector are currently provided with the powers and resources required in order to perform their role in the regulatory regime;

vi) the impact that the potential privatisation of Telstra would have on the effectiveness of the current regulatory regime;

vii) whether the Universal Service Obligation (USO) is effectively ensuring that all Australians have access to reasonable telecommunications services and, in particular, whether the USO needs to be amended in order to ensure that all Australians receive access to adequate telecommunications services reflective of changes in technology requirements;

viii) whether the current regulatory environment provides participants with adequate certainty to promote investment, most particularly in infrastructure such as optical fibre cable networks;

ix) whether the current regulatory regime promotes the emergence of innovative technologies;

x) whether it is possible to achieve the objectives of the current regulatory regime in a way that does not require the scale and scope of regulation currently present in the sector; and

xi) whether there are any other changes that could be made to the current regulatory regime in order to better promote competition, encourage investment or protect consumers.

(2) *That the committee make recommendations for legislative amendments to rectify any weaknesses in the current regulatory regime identified by the committee's inquiry.*

Effectiveness of Part XIB in dealing with instances of abuse of market power

3.2 Optus believes that the application of Part XIB requires some improvement in terms of the transparency of the process and the relative size of the competition notice penalties.

3.3 Part XIB has minimal predictability and provides little guidance in terms of clear key regulatory principles to be abided by. It is a reactive tool for the regulator, and its use involves greater uncertainty and risk for market participants as compared to the access regime.

3.4 An examination of the recent competition notice that was issued on Telstra in relation to the claimed wholesale DSL price squeeze shows where these improvements would be valuable. For example, there was considerable uncertainty, once the notice had been issued, as to the approach the ACCC would take to achieve the final resolution of the issue.

3.5 In particular, the ACCC dealt with Telstra's anti-competitive behaviour behind closed doors. There is little transparency into the details of the arrangement reached between the ACCC and Telstra in dealing with the matter. Further, there has been little consultation with industry about the new measures the ACCC has agreed with Telstra.

3.6 The pecuniary penalty payable for a contravention of the competition rule is capped at the sum of $10 million plus $1 million for each day that they contravention continued. Optus posits that this cap may be too low to pose any real threat to an organisation as large as Telstra. For example, the penalty imposed on Telstra for the wholesale DSL competition notice after almost one year was only $6.5 million (the regulator was able to charge more than $300 million under the cap). For a company the size of Telstra this size of fine is likely to be viewed as merely a cost of doing business: it is unlikely that it is something that would necessarily influence its future conduct.

3.7 Optus considers that a flaw in Part XIB is the overarching requirement to demonstrate a substantial lessening of competition. In many cases Telstra can get away with giving resellers like Optus poorer connection times and repair times, and higher prices, than to its own retail operations because it judges that we would not be able to show to a court that the particular instance involved a substantial lessening of competition. This is so even if the cumulative impact is very serious. That is why Optus has proposed a non-discrimination rule.

3.8 The non-discrimination rule (NDR) is detailed above in paragraphs 2.90 to 2.94, and will mean that instead of competitors having to demonstrate that Telstra's behaviour is anti-competitive by substantially lessening competition, Telstra would need to demonstrate that it was not behaving in a discriminatory manner, so complying with the NDR. This is an important change that shifts the onus of proof onto Telstra to demonstrate compliance with the rule, rather than the much higher test for non-Telstra providers to demonstrate that Telstra is not only behaving anti-competitively, but that this behaviour is having a significant impact on competition.

Flaws in the operation of Part XIC

Access regime

3.9 Optus supports the operation of the access regime. It continues to be a crucial tool for us in gaining access to Telstra's network for a whole range of services. Indeed we spend over one billion dollars a year with Telstra for the use of its network.

3.10 Model (price and non-price) terms and conditions are largely ineffective, they are not binding on access providers and have in practice been generally superseded by the undertakings process which consumes significant time and resources.

Accounting separation regime

3.11 It is widely acknowledged that the accounting separation regime has not achieved what the Government may have initially envisaged it could achieve in terms of revealing and preventing discriminatory behaviour by Telstra. Optus has faced discrimination by Telstra at each of these three level listed below:

- Refusal of the wholesaler to sell monopoly services to competitors
- Provision of higher performance processes by the wholesaler to its retail business than to competitors.
- Provision by the wholesaler of lower access prices to its retail business than to competitors

3.12 Optus believes that the existing Part XIC regulatory tools are incapable of addressing these problems in full. The existing tools are time consuming, complex and costly to apply, while others are ineffectual due to being non-binding and applying only to declared services.

Operational separation

3.13 There is a current proposal to introduce operational separation on Telstra by introducing measures that improve access seekers' ability to compete against Telstra. An effective operational separation model would need to include:

- The establishment of Telstra's access division as a separate operational entity. Under this measure, Telstra Retail would acquire the same services as access seekers. A transfer price would be clear and visible, and Telstra Retail and Telstra Wholesale could be required to prepare accounts based on retail prices.
- The establishment of requirements for price and non-price non-discrimination by Telstra Wholesale, i.e. a clear non-discrimination

rule. Enforcement action to address breaches of the non-discrimination requirements could be obtained in the absence of proof that the breach has resulted in a substantial lessening of competition.

- The creation of monitoring and reporting requirements for the regulator on measures of discrimination. Such monitoring could focus on, for example, the access prices that Telstra charges its retail division compared with those charged to its competitors, and the Service Level Agreements (SLAs) applicable to Telstra Retail compared to those of its competitors.

3.14 These measures should apply only to the incumbent carrier; not to other carriers, and Telstra should not obtain freedom from access regulation in return for implementing operational separation, as has been proposed to the UK regulator by British Telecom.

3.15 Optus suggests operational separation be openly debated with all stakeholders involved. This debate needs to centre around key signposts of success. Key questions that need to be asked are whether the arrangements will result in:

- Telstra fairly pricing of wholesale services between itself and its competitors
- Telstra treating its wholesale customers fairly by giving them access to the same terms and conditions for services
- meaningful tracking and reporting of the reforms
- regular reviews that enable the effectiveness of the reforms to be checked.

3.16 Then at the end of the day, it may result in alternatives to operational separation being found that can achieve these objectives through easier to implement, more timely arrangements.

Whether current consumer protection safeguards provide effective and comprehensive protection

3.17 Optus believes that the Government's price controls are too obtrusive and do little to protect consumers. This form of consumer protection should be more targetted at the areas of concern.

3.18 If there is concern over equity issues or the welfare of rural or low income users then Optus would urge the government to consider specific targeted measures to address these objectives. This can be done through limited price control measures or through alternate welfare schemes.

3.19 An example of the successfully targeted measures is the requirement for Telstra to have in place low-income packages that are approved by low-income advocacy groups. Consistent with this requirement Telstra currently offers packages targeted at holders of Pensioner Concession cards, Health Care cards and Low-income health care cards. Since holders of these concession cards are likely to have lower than average incomes, this scheme is successful in meeting the government's objection of directing social benefits to those who should receive those benefits. Optus supports the maintenance of the current Telstra funded low-user requirement.

Powers and resources of regulators to perform their role

3.20 It is essential that the ACCC has sufficient powers, and sufficient resources, in order that it pose a credible regulatory threat to Telstra. This is particularly important if Telstra is to be fully privatised and the regulation to be tightened over monopoly services.

3.21 The ACCC should be provided with additional power to move more quickly to block Telstra's anti-competitive behaviour. Specific measures that need to be introduced might include (these are discussed in more detail below in this submission):

- A prohibition on Telstra unreasonably discriminating in favour of its own retail operations; and
- Measures that prevent Telstra targeting customers it has lost to competitors for 180 days (such measures are in place today in Canada).

Potential privatisation of Telstra on the effectiveness of the regulatory regime

3.22 Competition is potentially under threat if Telstra is fully privatised. Information asymmetries mean that a privatised Telstra has more ability to act in an anti-competitive way.

3.23 Telstra's inherent market power, which arises from its incumbency, will be unfettered because it will be freed of two existing obstacles that partially constrain its behaviour: its majority Government ownership and its incentive to be on its best behaviour in the run-up to full privatisation.

3.24 If Telstra is to be fully privatised, the Government must ensure that the telecommunications regulatory regime is appropriately structured so that the right incentives are created so that any regulation promotes facilities-based competition.

Does the USO ensure reasonable access to services for all Australians

3.25 Optus has provided its views about the future of the USO above. What is important is that a recent comprehensive review of the USO by the Department of Communications, Information Technology and the Arts recommended that Telstra should absorb the cost of the USO.

3.26 If the Government is to ignore its Department's advice by continuing to pursue funding from some form of industry levy, then it is appropriate that this include an infrastructure offset enabling providers to use their own USO levies to fund their own infrastructure investment in rural and regional services.

3.27 This is far more preferable to the USO funds being put into a pool of funds that can be drawn upon in some ad hoc manner (which history has shown would tend to favour Telstra).

Investment certainty and promotion of innovative technologies

3.28 The key measure for creating investment certainty and innovation is to create an environment that encourages effective infrastructure competition. This can be achieved through the following measures listed in preferential order for achieving competition outcomes (explained above):

- Optus' Bridge to Broadband proposal
- Removing the disincentives effects the USO and taking the opportunity to use the funds for non-Telstra providers to invest in rural and regional broadband technologies
- Looking at reforming the competition regulatory regime so Telstra is required to behave more fairly in how it treats its competitors that rely on it for wholesale services
- Streamlining the competition regime so it is more responsive to anti-competitive activities.

Reduction on scale and scope of current regulation

3.29 This issue is discussed above.

Other changes to promote competition, investment certainty and protect consumers

3.30 All these issues have been covered above.