Competitive

Carriers'

Coalition Inc

# The Impact of Internal Operational Separation of Telstra on Present Regulatory Arrangements – Overview Paper Discussion Draft

March 2005

Reducing Regulatory Costs and Increasing Investment

(Paper 3 in the CCC Revitalising Competition Policy Papers Series)

## Background to this paper

This paper is one of several being prepared by the CCC to provide an expansion on some of the issues raised in the CCC's January 2005 discussion draft paper *Revitalising Competition in Australian Telecommunications – Proposals for Policy Reform.*

The CCC does not at this time advocate a particular option, but seeks to stimulate debate and help focus further discussion on the merits of different policy approaches to achieving effective structural reform. Feedback from the overview paper has identified a number of key issues requiring further discussion. One of those is the opportunity for reducing the regulatory burden through addressing barriers that have emerged to effective competition since 1997. That issue is addressed in this paper.

The CCC again invites comment and suggestions as to where greater focus or investigation would be useful.

## The Inherent Competition Problem and the Role of Internal Operational Separation

As discussed in the CCC's policy proposals overview paper, the core problem that arises from Telstra's unparalleled vertical and horizontal integration – that it has the incentive and the means to discriminate against those carriers seeking access to its bottleneck and monopoly infrastructure to the detriment of competition – cannot be completely removed by any measures short of actual structural separation.

The CCC understands that structural separation is not a policy option under consideration at this time. Therefore, the CCC has looked to alternative approaches that address the internal arrangements inside Telstra and how they might be changed in ways that address the points of competitive failure.

The goal driving the design of an internal operational separation model (i.e a ring fencing model) must therefore mitigate the problem as much as possible. Internal operational separation seeks to replicate within Telstra as far as possible the behaviour that could be expected to be observed if Telstra was not structurally integrated, but was a set of independent businesses interacting with other market participants.

The CCC believes that the Telstra privatisation process provides an important opportunity to implement new arrangements with the view of fostering a healthy and sustainable competitive industry.

## The Present Arrangements

When the legislative changes to open telecommunications markets in Australia to competition were introduced in 1997, it was anticipated that a number of the regulatory

measures put in place at the time would be transitory. It was anticipated that as competition matured, the level and extent of regulation would decrease.

In fact, the opposite has been the case.

There have been a series of interventions by various regulators and significant legislative changes that are a direct consequence of competition failing to take root in some markets, or to grow in others.

These regulatory interventions have led to an ever more complicated regime for businesses, regulators and consumers alike. The growing regulatory burden itself has come to weigh against competition. This is because the growing regulatory burden is most felt by smaller and newer entrants.

**The Burden of Regulation – A Summary**

Licensed carriers in Australia face having to comply with a list of regular reporting requirements from numerous regulatory and policy agencies. In addition to these, there are numerous reports and inquiries each year into specific issues.

In both cases, there is often duplication across the activities of the various agencies.

Below is a list of some of the regular reports that carriers in Australia are required to provide to various agencies. Some of them have only recently been introduced.

ACA
1. Universal Service Obligation eligible revenue return
2. Customer Service Guarantee quarterly report
3. Annual performance report (s105 report)
4. Proposed Record Keeping Rules to monitor industry performance in regional, remote and rural areas (an outcome from the Regional Telecommunications Inquiry). These appear to overlap with CSG.
5. Underground facilities report (each 18 months)

DCITA
6. Annual Industry Development Plan report. The Government sought to abolish this requirement in 2002, but the Parliament was not satisfied that the industry could be relied upon to invest adequately without oversight, and the requirement was retained. Whilst subsequently the IDP has been partly wound back, the CCC would argue that this lack of confidence by the Parliament was indicative of the failure of competition.

ACCC
7. Annual competitive safeguards report (Division 12 report)
8. Annual market indicator report

9. Six monthly Regulatory Accounting Framework report
10. Bimonthly broadband infrastructure report (appears to overlap with ACA report No. 6 above)
11. Annual report on prices paid by consumers for telecommunications services
12. Internet peering RKRs (introduced in 2004)
13. Corporate competition market RKRs (Introduced in 2004)
14. Half yearly report into competition in the corporate market segment. (Introduced in 2003)

The last three items are once again indicative of the failure of competition to develop effectively, leading to attempts by regulators to gather more and more data in the hope that eventually they will be able to identify anti-competitive activity. To date, this has not been successful because the information gathering is necessarily complicated, targeted (in some cases) at the wrong respondents, confused and casts a very wide net.

Other efficiencies could be achieved from a clearer separation of Telstra's wholesale activities would relate to price regulation. It would be much easier to bring regulation of telecommunications onto the same basis as applies in other countries such as the US, where identified monopoly elements are regulated through price setting arrangements.

Changes to allow the ACCC to set prices for these services would replace the failed and complicated system where the ACCC nominates indicative prices, arbitrates disputes over prices where commercial negotiation can be seen to have failed, has to assess undertakings from access providers, and then must defend its decisions in undertakings cases on appeal (i.e. to the Australian Competition Tribunal).

The complication derives from the belief that the telecommunications industry can be treated as though genuine commercial negotiation is possible and can be encouraged. Experience has shown this to be a flawed premise. The reason is that commercial negotiation requires both parties to the transaction to have a degree of bargaining power. In telecommunications Telstra as the dominant player controlling essential upstream inputs, retains the bargaining power. Its competitors have no bargaining power to bring to the table.

It is also instructive to note that the ACCC's regulation of the gas and electricity markets has removed the negotiate/arbitrate/undertake/appeal incentive on suppliers so that, absent acceptable undertakings on price, the ACCC's rates apply. Unfortunately, the Telecommunication's sector is still stuck with the flawed model.

It is therefore unsurprising that even after eight years, prices for the most basic services continue to be in dispute. The CCC believes it is clear that a simpler, quicker set of arrangements are needed.

**Regulation That Could Become Redundant – Some Examples**

The CCC believes that an alternative approach to confronting Telstra's market dominance is now the only way that this explosion of regulatory intervention can be reversed. In a separate paper, *Options for Internal Operational Separation of Telstra*, the CCC has outlined several approaches to achieving this through creating ring fencing and reporting arrangements inside Telstra, and discussed the relative merits and limitations of the options.

There is a correlation between the limitations of those options and the potential for the removal of various regulatory mechanisms designed to overcome the short-comings in the present regime. Clearly, the greater the transparency and the less the scope or opportunity for Telstra to discriminate against access seekers in favor of itself, the greater the scope for regulation to be removed.

Potentially, all of the list of regular reports detailed above could be removed – some immediately and some over time – if effective competition were achieved.

That said, following is a list of examples of specific regulatory mechanisms that the CCC believes could be made redundant if effective internal structural separation were achieved, with an explanation of why they would be unnecessary. This is not a comprehensive list, but even if only these mechanisms were removed, the reduction in the resource burden would be very significant.

*Price Control Arrangements*
The intention of the price control arrangements placed on Telstra in various product markets was to protect consumers from Telstra using its market power in uncompetitive markets. It was intended that these would be removed over time as competition established itself in more markets.

Price controls have become highly politicized in the past eight years, and there is strong evidence that Telstra has in fact been able to use the mechanism to cross-subsidise from consumer markets to more competitive corporate markets. As a result, the real cost of residential telecommunications services have increased whilst larger business customers have enjoyed substantial reductions.

A reinvigorated competitive framework would create an opportunity for the future of the price control arrangements to reflect the original intention – that they are wound back as competition develops.

*Existing Record Keeping Rules*
Record Keeping Rules have increasingly come to be used as a square peg in a round hole as the ACCC has attempted to find ways to use them to progress matters that cannot be resolved through Part XI B competition notices or Part XI C declaration inquiries because of the difficulty of gathering evidence.

Recent examples have been record keeping rules in relation to corporate markets and internet interconnection. These are areas that have attracted complaints of anti-competitive conduct or anti-competitive arrangements for some years.

The ACCC has failed to gather sufficient evidence to reach a conclusion on its XIB or XIC investigations, but has gathered enough evidence to be concerned that a problem may exist. As a result, it has attempted to use RKRs to penetrate the accounts of Telstra and other carriers in the hope that this will provide it with a clear window on what is happening in these markets.

However, this has not been successful to date. The imposition on the industry of meeting the RKRs is substantial, often requiring carriers to develop new systems to capture the particular information requested.

Depending on how internal operational separation was introduced, it is likely that this use of RKRs would become redundant and their future use much better targeted.

*Accounting Separation*
Accounting Separation was introduced in the legislative amendments package of 2002. It was intended to provide some insight into Telstra's costs and pricing relationships.

Accounting separation has been expensive, resource intensive and controversial for Telstra, other carriers and the ACCC alike. It has also been a failure, as reflected in the comments of the ACCC about its limitation in theory and practice.

The accounting separation regime delivers information that is limited in product scope, so high level in output as to be irrelevant, and constructed wholly artificially and therefore divorced from actual operational decision-making in Telstra.

It could be completely discarded if a regime of proper internal operational separation was introduced.

*Undertakings*
The CCC has contended previously that the undertakings process in telecommunications has been systematically gamed by Telstra as a means of delaying the resolution of pricing concerns in relation to core services. For example, through 2004 and 2005, the ACCC and industry was forced to respond to three different sets of undertakings in relation to Unconditioned Local Loop (ULLS) and Line Sharing (LSS) services. Telstra withdrew the first two sets of submissions just before the ACCC published a final determination, and replaced them with new undertakings, requiring the whole process to start again from scratch. Similar abuses of the process occurred in relation to PSTN interconnect.

If internal operational separation was introduced successfully, it is likely that Telstra would have an incentive to move quickly to establish clear price, terms and conditions, because it would experience the same uncertainty as the rest of the industry if Telstra Wholesale continued to prevaricate.

*Service Declarations*
While the declaration of bottleneck services would continue to be an important core element of the regime after the introduction of internal operational separation, it could be expected that certain purely wholesale products could be removed from the list of declared services over time. For example, declarations on transmission services should be able to be more quickly removed if there was confidence among competitors that the prices, terms and conditions that they faced did not disadvantage them against Telstra, although the ACCC will continue to be concerned not to allow for monopoly rents to be extracted where there is only one or two service providers.

*Customer Service Guarantee*
The Customer Service Guarantee is another regulatory mechanism that tries to act as a proxy for effective competition. The existence of the CSG and its associated reporting obligations are intended to give consumer comfort that they can rely upon a regulated minimum level of service. The need for it should, like price controls, recede over time.

However, there would be shorter term benefits. If Telstra was internally operationally separated, the CSG obligations would properly fall on the wholesale part of that business where it provides the access to the core service. The immediate effect of this would be that the CSG obligation would become enshrined in contracts between Telstra's wholesale business and the retail service providers. This would create an opportunity for the regulator to correctly identify the source of failures to meet CSG obligations. Such a change would address a source of concern to competitive carriers, who presently are identified as failing to meet CSG obligations in circumstances where they are completely reliant on Telstra.