Australian
Competition &
Consumer
Commission

SUBMISSION TO SENATE ENVIRONMENT, COMMUNICATIONS, INFORMATION TECHNOLOGY AND THE ARTS COMMITTEE

Inquiry into the performance of the Australian telecommunications regulatory regime

April 2005

Introduction

On 10th March 2005 the Senate instituted an inquiry into the performance of the Australian telecommunications regulatory regime. The inquiry is being undertaken by the Senate Environment, Communication, Information Technology and the Arts Committee ('the Committee').

The Committee is to report back to the Senate by 23rd June 2005 and has called for submissions by 8th April 2005.

The Australian Competition and Consumer Commission (ACCC) welcomes this opportunity to provide input into the Committee's deliberations on these matters.

The Committee's terms of reference are set out in Attachment A to this submission.

In its recent inquiry into the provisions of the Australian Communications and Media Authority Bill 2004 ('the ACMA Bill') the Committee made a number of recommendations in relation to the structure of the telecommunications industry and the powers of the ACCC.

The terms of reference for that inquiry included the following:

> .....whether the powers of the proposed ACMA and the ACCC will be sufficient to deal with emerging market and technical issues in the telecommunications, media and broadcasting sectors

The ACCC made a submission to the ACMA Bill inquiry and considers it is worth re-iterating a number of the points it made at that time.

This submission also provides some additional comments in relation to the specific terms of reference for the current inquiry. In particular, it sets out a model of 'operational separation' of Telstra which – in the absence of other structural reform advocated by the ACCC in the past - has the potential to offer pro-competitive efficiency benefits.

The submission also comments on anti-competitive conduct, and the issue of investment in telecommunications infrastructure, by users of such infrastructure, and in innovative technologies.

Competition regulation of telecommunications

It is important to note that competition regulatory powers are dependent on the nature of the regulatory problem that they are seeking to address. This, in turn, depends on a range of issues including the presence of market power, the existence of natural monopoly and the incentives of an incumbent firm to hinder access and restrict competition.

In the telecommunications context, the ACCC has previously commented on the degree of industry integration in its *Emerging Market Structures Report*[1]. More recently, the Productivity Commission has commented on structural issues in the draft report of its review of the National Competition Arrangements[2]. The ACCC does not intend to respond to these issues again in this submission. Instead, given the existing industry structure, the ACCC intends to comment on the current regulatory arrangements.

The current regulatory regime was introduced with the deregulation of the telecommunications sector in 1997. Changes to the *Trade Practices Act 1974* (TPA) saw the introduction of the telecommunications-specific access regime (Part XIC) and anti-competitive conduct provisions (Part XIB). These provisions apply in addition to the general access and competition provisions that apply to the economy more broadly, as contained in Parts IIIA and IV of the TPA respectively.

Access arrangements are one of the cornerstones of telecommunications regulation in Australia. They provide a mechanism by which competitors can use bottleneck infrastructure inputs controlled or supplied by another provider when it is uneconomic for these inputs to be duplicated, so that they can supply their own services in downstream markets. Declarations for access to wholesale telecommunications services have permitted a range of carriers and carriage service providers to use Telstra's infrastructure to provide their own retail services. This has been one of the main ways of introducing competition across a range of telecommunications services and has led to associated price, variety and service quality gains to consumers.

Part XIB of the TPA provides mechanisms to address breaches of the telecommunications-specific 'competition rule'. Under the rule, a carrier or carriage service provider must not engage in anti-competitive conduct. A carrier or carriage service provider is said to have engaged in anti-competitive conduct if it has a substantial degree of market power in a telecommunications market and takes advantage of that power with the *effect*, or *likely effect*, of substantially lessening competition. In comparison, the general anti-competitive provisions in Part IV of the TPA have a higher *purpose* threshold.

In introducing the telecommunications-specific regime, the Government considered that total reliance on the general provisions in Parts IIIA and IV of the TPA would not achieve its objectives as, among other things[3]:

- telecommunications is a complex, horizontally and vertically integrated industry;
- anti-competitive cross-subsidies by the incumbent from non-competitive markets to markets in which competition exists or is emerging is a particular threat to the establishment of a competitive environment;

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1 The ACCC *Emerging Market Structures Report* (2003) is available online at www.accc.gov.au.

2 The draft report of the Productivity Commission Review of National Competition Arrangements is available online at www.pc.gov.au.

3 For full details, refer Explanatory Memorandum to the *Trade Practices Amendment (Telecommunications) Bill 1996*, p 6.

- due to the fast pace of change in the industry and the volatile state of the industry, anti-competitive behaviour can cause particularly rapid damage to competition; and

- there is considerable scope for the incumbent to engage in anti-competitive conduct because competitors in downstream markets depend on access to networks or facilities controlled by the incumbent.

The ACCC is of the view that the significance of these factors has not diminished over the time that the telecommunications-specific regime has been in place.

There has been recent interest in the potential impact of new technologies, most notably voice over internet protocol (VoIP), wireless local loop and, to a lesser extent, fibre to the home, to break the dominance of the incumbent fixed-line network and lead to more sustainable competition. The ACCC takes the view that, while there may be potential for greater competition as a result of these services, their impact has not yet been demonstrated. In such a setting, it is premature to suggest that there is a reduction in the need for regulatory oversight.

Indeed, it is possible that instead of weakening existing market power, there is a great incentive for incumbents to respond to investment by competitors in new technologies, such as wireless, by using that market power to foreclose possible competition.

Since 1997, various measures have been adopted to strengthen the access regime to improve its effectiveness. Most recently, new measures have included removing a second layer of merits review for ACCC arbitration determinations, publishing indicative prices for Telstra's copper access network services and the enhanced accounting separation of Telstra's wholesale and retail operations.

As a result of these processes, there is now an extensive suite of regulatory arrangements in place. These arrangements provide a generally flexible framework that is applicable to new and emerging challenges in the sector. The ACCC has a central role in administering these arrangements and remains committed to rigorously doing so. Furthermore, in light of the degree of integration within the sector, the ACCC considers that it is appropriate, at a minimum, for this full suite of powers to be retained.

These comments regarding the general applicability of the regulatory regime notwithstanding, structural issues do impose limitations on the extent to which the enforcement provisions of Part XIB, and access provisions of Part XIC, can be applied in practice.

The ACCC has previously noted some specific concerns regarding the effectiveness of the current enhanced accounting separation arrangements. Specifically, the current accounting separation is nominal in that it only requires Telstra to collect and report information. It does not require the carrier to reorganise its internal affairs and operate as if it were running two or more discrete businesses.

A more rigorous form of 'operational separation' along these lines would weaken the incentives for Telstra to engage in discriminatory and other types of anti-competitive

behaviour, as well as offering a superior means of identifying and rectifying it. Operational separation arrangements could serve to further strengthen the ACCC's ability to administer the existing range of telecommunications-specific access and anti-competitive conduct provisions.

The following section outlines in more detail how such a model would work.

Operational separation of Telstra

The lack of transparency in the way that Telstra operates is a significant impediment to the effectiveness of the telecommunications-specific provisions of the TPA in promoting competition.

Previous attempts to address this issue, however, such as the introduction of the enhanced accounting separation regime in 2002, have not succeeded in giving the ACCC a satisfactory handle on the way that Telstra operates its business.

The accounting separation regime was originally intended to provide greater transparency in the way Telstra conducts its retail and wholesale operations, thereby enabling the ACCC to easily identify any discriminatory behaviour towards rivals seeking access to its network.

However, information provided by Telstra under these arrangements is highly aggregated, which can hide specific instances of anti-competitive behaviour requiring more detailed analysis. It is significant that the ACCC has relied on the existing accounting separation arrangements to only a very limited extent in relation to its imputation testing analysis of specific cases.

More importantly, the primary limitation of the accounting separation arrangements is that they require only a notional allocation of costs across the wholesale and retail businesses.

As noted above, the arrangements do not require the carrier to reorganise its internal affairs and operate as if it were running two or more separate discrete businesses. In the absence of structural reform, stronger measures along these lines would offer a far superior means of both detecting and fixing anti-competitive behaviour.

Regulators in other jurisdictions are looking at such measures. The UK telecommunications regulator Ofcom has called for greater separation of BT's wholesale and retail operations as part of its *Strategic review of telecommunications*. Ofcom has proposed that BT deliver 'equivalence of access' to its wholesale customers, and also introduce internal changes to reduce the incentive for BT to discriminate in favour of its own retail operations and against its wholesale customers.

In the Australian context, there already exist models for distinctly identifying or 'ring-fencing' the monopoly and competitive activities of utility companies within the energy sector. Both the National Gas Code and mandatory guidelines issued by the ACCC under the National Electricity Code contain ring-fencing provisions that have been in operation for some time. Under these provisions, utilities are required to maintain separate legal entities for their internal business units.

These arrangements do not preclude the separate businesses from being owned by the same shareholders, but they improve transparency and address underlying incentives to engage in discriminatory behaviour.

In relation to Telstra, there would need to be an internal separation between a 'retail business' supplying services to end-users, and a 'network business' supplying wholesale services not only to those seeking access to network services - so they can compete with Telstra's retail business - but also to the Telstra retail business itself.

In order to be effective, such separation would need to be underpinned with formalised arrangements, including requirements that the two businesses:

(1) deal with each other on a commercial, arms-length basis, including explicit pricing, invoicing and billing;

(2) maintain fully separate accounts and financial and non-financial reporting systems, capable of capturing all transactions between the businesses; and

(3) maintain separate staff at all levels, with staff remuneration tied exclusively to the performance of the relevant separated business.

Anti-competitive conduct

The above discussion of operational separation highlights one of the ACCC's core concerns regarding the current telecommunications regulatory framework; namely that the current lack of transparency in the way Telstra operates is a significant impediment to the effectiveness of Parts XIB and XIC of the TPA.

For example, in the case of the recent Part XIB broadband pricing matter, the lack of genuine internal pricing by Telstra created substantial difficulties for the ACCC in establishing anti-competitive conduct by Telstra. As such, the ACCC was forced to rely on imputation testing, a much more limited analytical tool to infer an implicit price at which Telstra is supplying wholesale services to itself.

Genuine arms-length dealings between Telstra's retail and network divisions would therefore be a significant improvement on the current situation.

Investment

The impact of regulatory decisions on investment incentives is an integral component of regulation. Investment issues are complex and the ACCC recognises that ongoing efficient investment is in the long-term interest of end users of telecommunications services. The ACCC always gives the issue significant consideration in making regulatory decisions, and generally takes a cautious approach, tending to provide returns that err in favour of the service provider.

The ACCC would emphasise that the provisions of Part XIC of the TPA already enable the regulatory settings to be determined in advance of any new investment being made, thereby providing the requisite degree of regulatory certainty that

potential investors seek.[4] These provisions range from a complete exemption of the new assets from any access obligations to the imposition of a more limited access regime through special undertakings.

Specifically, the *Telecommunications Competition Act 2002* amended part XIC of the TPA to:

- give the ACCC the power to grant anticipatory exemptions from the Standard Access Obligations for carriers and carriage service providers that expect to supply a service – s.152ATA; and

- give the ACCC the power to accept special access undertakings from carriers and carriage service providers that expect to supply a service – s.152CBC.

The anticipatory exemption provisions under s.152ATA have been utilised by Foxtel and Telstra to apply for anticipatory individual exemptions from standard access obligations (SAOs) in relation to digital subscription television services.

The ACCC made a decision to accept Foxtel's and Telstra's applications, however the Seven Network subsequently lodged an application for review of the ACCC's decision with the Australian Competition Tribunal. In September 2004 the Tribunal issued its decision to refuse the applications for exemption by Foxtel and Telstra.

The ACCC considers that the Tribunal's decision not to grant the exemptions was based on the particular facts of this matter, and should not limit the ACCC's ability to grant such exemptions in future.

As such, the ACCC's view is that these mechanisms will continue to be effective and appropriately flexible in fulfilling the objective of providing regulatory certainty before investment decisions are made.

Any such decision by the ACCC would depend on the nature of the application made by the parties and an analysis of the underlying technical, commercial and economic issues raised. The ACCC must ultimately be satisfied that granting an exemption or accepting a special access undertaking is in the long-term interests of end users.

An application for regulatory certainty which also involves third-party access rights would also have to address the appropriate access price. In this regard, the ACCC would be mindful of ensuring facilities owners are properly compensated for all their costs that are reasonably and efficiently incurred in building and operating the asset, including a sufficient return to capital (including shareholders) commensurate with the risks that would be involved in such an investment.

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[4] Section 152ATA allows the ACCC to grant anticipatory access exemptions. That is, services that are not declared (and which may not even be provided until investment occurs) may be granted exemption from declaration for the purposes of access regulation. Section 152CBA also defines 'special access undertakings' which the ACCC may accept in relation to services that are not declared. This might be used by a party to seek certainty before it invest in new assets, and which may be providing new services, over the terms and conditions on which it might be required to provide access to those services.

To date, neither Telstra nor any other party has indicated to the ACCC that it has firm intentions in relation to investment in technologies such as fibre-to-the-home. Indeed, Telstra admits it actually has no current plans for any significant investment in fibre-to-the-home and claims the existing copper network has another 15-20 years of useful life in front of it[5].

In relation to the apparent US policy of providing exemptions to incumbent carriers for investment in fibre networks, the ACCC notes that the US industry has a substantially different structure to that of Australia. Unlike Australia, there is considerable and growing competition between telecommunications and cable TV providers for broadband, Pay TV and telecommunications services. This degree of inter-modal competition has significant implications regarding the need for access regulation, but is unlikely to be replicated in Australia in the immediate future.

[5] Bill Scales testimony to Senate Communications Estimates Committee, 14 February 2005, p.114.

Attachment A: Inquiry Terms of Reference

The Committee's terms of reference are:

(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:

(a) 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;

(b) 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;

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

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

(e) 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;

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

(g) 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;

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

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

(j) 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

(k) 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.