Senate Committee Submission

The Environment, Communications, Information Technology and the Arts References Committee of the Australian Senate has initiated an Inquiry into the performance of the Australian telecommunications regulatory regime. This process is welcomed and it is hoped the following brief comments assist the Committee in its deliberations.

Introduction

It is important to acknowledge firstly that the issues before the Committee are not unique to telecommunications. The dilemmas and concerns are endemic to network-based sectors – it is only the intensity that varies. The issues are especially acute in telecommunications because of the pace of technological advancement and the cultural significance of the products that rely upon such infrastructure.

The core proposition of this submission is that the current debate over infrastructure regulation is bogged down in detail and futile argument. As expressed by Queensland Rail in a submission detailing its strategic concerns with the regulatory regime for rail:[1]

> Concerns with the current access regime cannot be resolved at the level at which it operates. Arguing over the components of an appropriate rate of return, what constitutes sufficient information transparency or the merits of vertical separation are not, of themselves, likely to present a solution. A growing appetite for more-and-more detail on the commercial activities of a regulated entity is not going to yield an answer to what are likely to be "big picture" questions.
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> QR is of the view that the existing conflict must be elevated and examined with reference to the core aspects of the economic framework that led to it being created.

This submission deals with two inter-related big picture issues:

- the inclination to believe that regulation is positive, insofar as it "promotes" efficiency; and
- the inability to prove the efficacy of regulation.

The following comments are also supported by the attached article on regulation, which was recently published in *The Australian Financial Review*.

Regulation is Always a Cost

The concept of regulation is at odds with the economic policy framework within which it has been developed. Market principles tell us that a third party cannot adequately appreciate the "intimate" dimensions of the relationship between a buyer and seller. Governments have been encouraged to remove commercial controls and restrictions because it has been generally accepted that attempting to second-guess the forces that lead the free market to optimise the flow of resources into their best use, is a losing strategy.

It is this principle that has seen the demise of political systems that attempt to control individual behaviour or promote government intervention in areas of private

[1] Queensland Rail, "Towards an Effective Access Regime", submission to the Australian Logistics Council, August 2003 (see http://www.networkaccess.qr.com.au/Images/Effective_Access_Regime_tcm10-2848.pdf)

consideration. The apparent tension between mandating certain requirements of infrastructure owners and the free market philosophy was noted by the Committee responsible for framing National Competition Policy (NCP):[2]

> The efficient operation of a market economy relies on the general freedom of an owner of property and/or supplier of services to choose when and with whom to conduct business dealings and on what terms and conditions. This is an important and fundamental principle based on notions of private property and freedom to contract, and one not to be disturbed lightly.

According to the economic theory upon which our policy framework is based, regulation of infrastructure is inefficient, insofar as it compromises the absoluteness of this principle. It's a cost to society.

Infrastructure regulation can be sensibly supported, however, if such costs are less than the inefficiencies associated with natural monopolies – most notably over-pricing and restricted supply. During the reform process over the last ten years this fact has been forgotten. Regulation has created a positive image for itself. This misconception seems to have extended to even the terms of reference of the Senate Committee. Part (i), for instance, asks "whether the current regulatory regime promotes the emergence of innovative technologies".

The simple answer to this is "no, it cannot". What regulation can do is attempt to limit the potentially detrimental impacts of infrastructure owners who are not exposed to the checks and balances of a competitive market. The central proposition with infrastructure regulation is: are the costs of regulation greater than the costs of not regulating? It is not: what are the benefits of regulation because there are none, *per se*.

Infrastructure regulation can therefore never be "positive" of itself. Posing a question that presumes it is innately beneficial indicates a misunderstanding of the fundamentals that is likely to lead to compounding policy errors.

Such realisations are rarely acknowledged. It is certainly not institutionalised into our democratic processes and day-to-day thinking when it comes to policy and legislation. This seems to have come about because the policy-makers who framed the regulation regime did not want to admit that regulation was innately "bad", as it would have given inefficient infrastructure owners the opportunity to suggest that there may be a point at which the costs of monopolistic behaviour become less than the costs of regulation.

The hidden liability with this approach is that it encourages the community to see regulation as something positive and effective in promoting efficiency, when it's not. None of the prosperity created in Australia during its period of economic reform from the late-1980s is due to regulation. Regulation may have played a role in the distribution of such wealth (which can be virtuous) but it did not generate or innovate anything in a more fundamental sense.

This vital distinction has become lost in the propaganda and politics associated with economic reform. As noted below, a denial of such has meant the reform process has effectively painted itself into a corner.

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[2] Independent Committee of Inquiry into Competition Policy in Australia or Hilmer Committee (1993), *National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia*, AGPS, Canberra, p. 252

Efficiency – and thus Regulation – cannot be Defined or Proved

The over-arching economic policy objective of "efficiency" is utterly vague. As noted by the Productivity Commission:[3]

> The ultimate objective of access legislation is to enhance community welfare. In an operational sense, however, this is difficult to convey in a meaningful way. To this end, the objective of Part IIIA [of the Trade Practices Act 1974] has been couched in terms of promoting competition in the delivery of infrastructure services.

Because efficiency cannot be properly defined it follows that economic policy choices and regulation endure a similar plight. Yes, there is plenty of science involving hard numbers and various quantifiable benchmarks, but there is always an element of expert judgement involved. This was realised by the Hilmer Committee:[4]

> Neither the application of economic theory nor general notions of fairness provide a clear answer as to the appropriate access fee in all circumstances. Policy judgements are involved as to where to strike the balance between the owner's interest in receiving a high price … and the user's interests in paying a low price.

Of course, this intuitive aspect of regulation was denied when the Commonwealth cajoled the states into a much-needed infrastructure reform program in the early-1990s. It was assumed lazy public sector energy and transport monopolies were itching for any excuse to avoid necessary change. Admitting to a gut feel ingredient would have provided this opportunity by opening the debate to unresolvable argument.

Initiatives like NCP were thus implemented amidst an aura of scientific certainty. There were qualifying statements like "competition is a means, not an end", but the deep-down intent was passionately unambiguous. Many came to believe success was indeed a mechanistic exercise: bust-up monopolies, privatise wherever politically feasible and enforce performance regimes. By extension, there was also a push to regulate everything that wasn't already feeling sufficiently threatened.

Regulation of telecommunications represents a paradoxical take on the general thrust of reform policy. On the one hand, the message is "freedom is efficiency", while the other has announced "you must do as you are told". This conflict has never been resolved.

While such a contradictory strategy was understandable during the transition from former vertically-integrated monopolies, ignoring it has also created a dangerous misconception that the positives of the market can be captured in a formula and administered by more-and-more powerful regulators. The policy intelligentsia, in its haste to deliver us from economic malaise, failed to see the trap it had set for itself: as the gains from reform accumulate, the harder it becomes to confess they weren't actually realised through regulation and other control-based initiatives.

This predicament has left various state governments clutching for simple-but-ineffective solutions to numerous electricity, port, rail and road dramas. Meanwhile, the Australian Competition and Consumer Commission (ACCC) deals with the situation by attempting to make it an empirical debate based on "evidence" like record investment in energy infrastructure and broadband take-up. Does Graeme Samuel really believe such numbers are sufficient to prove regulation is effective?

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[3] Productivity Commission (2001), *Review of the National Access Regime*, Report #17, AusInfo, Canberra (www.pc.gov.au)

[4] ibid, p. 253

The ACCC does itself and the community a great disservice by implying efficient infrastructure management and regulation is a matter of pure science. It confuses the issues, drags the debate into the detail and entrenches conflict.

This testing situation is now before the Federal Government and, indirectly, the Senate Committee. Senator Minchin pronounces vertical separation of Telstra a no-go. The Treasurer says excessive regulation would be detrimental. How are these views to be verified? That's the thing – they can't be.

It's equally legitimate to claim the opposite, especially when previous half-truths have inferred easy fixes like privatisation and burlier regulators. Rural constituents are criticised for their simplistic and costly suggestions, yet it was ardent reformers who engendered the naïve belief that all our needs can be met through open-ended transparency and an ever-growing regulatory presence.

Like efficiency and good policy, the question of whether or not regulation is beneficial requires judgement. Are the costs less than the costs of not having it? Such an assessment must have an intuitive element over-and-above hard numbers. Because judgement cannot be proved, it makes no sense to claim to know the right answer beforehand. That is, the reality concerning the efficacy of regulation of telecommunications will only be apparent if and when those involved in the debate first accept there is no pre-determined answer. For this to happen, of course, we need to be willing to let go of our prejudices and be open to the truth.

Conclusion

A Senate Report on the *Trade Practice Act 1974* made the following observation in respect of regulation:[5]

> The ACCC requires a tool which will enable it to act in 'real business time' yet which will protect the rights of companies.

While this statement is understandable, there simply is no such "tool" in existence – and there never will be. If, on the other hand, we truly believe there is, then all efforts should be channelled into discovering what it is and adopting it as a logical improvement on the free market concept that has been so successful up to now.

An alternative view has an agreed solution on telecommunications and various other infrastructure difficulties being formed only after we acknowledge that our economic policy goal of efficiency cannot be captured, measured or even defined. The metaphoric "invisible hand" that has brought Australia its wealth is too fast for regulators. To believe otherwise will surely prevent our telecommunications sector from delivering all that we wish for the community and future generations of Australians.

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[5] Australian Senate Economics Reference Committee (2004), "The effectiveness of the *Trade Practice Act 1974* in protecting small business", Report, Parliament of Australia, March, p. xix (www.aph.gov.au).

The following appeared in *The Australian Financial Review* on 4 January 2005 under the title "Infrastructure on a journey of enlightenment".

Last year was surely an *annus horribilis* for infrastructure. Late trains, blackouts, suicide, toll-road dramas and, of course, further consternation over telecommunications. Does the new year offer any hope?

It's not too encouraging. We appear to be at a policy crossroads and no one is clear on which way to head. Going back is not an option. Still, you get the sense national regulation, public private partnerships and a general commitment to "get it right" won't quite be sufficient. It's all insufferably tentative – often confusing and always frustrating.

The dilemma can be identified, but remains uncracked. How does one neutralise the innate market power that defines infrastructure ownership? No known cure exists, yet it can't be left unattended when corporations are now, understandably, assumed guilty until proven innocent.

Telstra's Ziggy Switkowski has wrestled this no-win. Described in an editorial in *The Australian Financial Review* as a "refugee from a New Age spiritual retreat" (December 10), his internal efforts to curb Telstra's network clout have certainly been muddled but no more or less than the broader policy scene.

Maybe Zen is the way to go: "there are no solutions; only the futile search for answers".

Infrastructure awoke from its monopolistic slumber in the 1990s. We had inspired reforms involving structural reform, privatisation and greater competitive pressures.

Light-handed regulators posed the questions that other firms face every day. Can costs come down? What is a reasonable rate of return? Are my customers satisfied? This approach was successful, especially in terms of cultural change for public sector infrastructure managers.

Regulation, however, is not an end in itself. With substantial inefficiencies now behind us, Switkowski's dilemma has begun to bite. The resulting conflict is placing at risk all that has been achieved.

The 1993 Hilmer Committee on competition policy hinted at the predicament. It wanted ministerial access principles for infrastructure, exercised only as a last resort via binding arbitration. Appeals would be limited to matters of law.

It did not favour the creation of independent regulators setting access terms based on their assessment of conflicting details, as is the practice of bodies such as the Australian Competition and Consumer Commission.

"The central conundrum in addressing the problem of misuse of market power is that the problem is not well defined nor apparently amenable to clear definition," the Hilmer report says.

"Even if particular types of conduct can be named it does not seem possible to define them, or in circumstances in which they should be treated as objectionable, with any great precision.

"The challenge is to provide a system which can distinguish between desirable and undesirable activity while providing an acceptable level of business certainty".

In typical economic fashion, this real life problem was ignored.

"In addressing this challenge, the Committee starts from the position that there is already in place a regime which provides a basis for making the appropriate distinctions," the report says.

This unchallenged assumption has now come home to roost. The regulatory edifice is being revealed for what it really is – a bluff.

This is particularly apparent in the recent draft decision by the Queensland Competition Authority on access to port infrastructure managed by listed company Prime Infrastructure.

Details aside, this intractable process is not about ridding the economy of technical inefficiencies.

Prime is exposed to the disciplines of a competitive capital market. With no fat to carve out, the QCA has decided to second-guess the "right" price for an "efficient" coal terminal. Having led a few idle electricity and rail infrastructure horses to water, the QCA has convinced itself it can also make Prime drink.

This is folly. There is no sound policy basis for what the QCA has done. What is efficiency? What is market power? Has the QCA found the answer Hilmer couldn't?

Such home truths have been shrouded by the success of the initial phase of infrastructure reform. The *laissez faire* ideal upon which our policy framework has been built was compromised (subconsciously, it seems) in order to allow regulators to kick the heads of formerly protected monopolies. Fair enough.

But let's not kid ourselves. The ACCC and QCA cannot do the impossible and mandate efficiency. Governments and economists are doing the community a grave disservice by perpetuating the myth that regulation is some kind of saviour for our infrastructure anguish.

The first and foremost principle of regulation is that it cannot be the answer, regardless of what is has accomplished along the way. Regulators may be able to win a few battles, but they can't fight the "war" – that is reserved for corporations and their customers. Believing otherwise will be to our long-term detriment.

So, are Telstra and Prime intent on fleecing their network users? A fair question, to be sure.

Whatever the case, there is a much more vital concern: is the fear accompanying such an inquisition blinding us to the dreaded cost of institutionalising bad faith? For unsavoury corporate behaviour is definitely not a good thing, but what of the dead weight of paternalism?

Last year may have been tough for a reason. Maybe 2005 will be a watershed. Not in terms of a solution – just a formal acknowledgement that giving owners the opportunity to show their commercial maturity is the only way to break the vicious cycle of mistrust and political manoeuvring that is limiting infrastructure development in Australia.

Perhaps a new-year's resolution from Switkowski will be needed to get things moving: "Network regulation may be part of the journey, but it's not the destination."

ENDS

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