Inquiry into the Performance of the Australian Telecommunications Regulatory Regime

Submission by Telstra Corporation Limited to the Senate Environment, Communications, Information Technology and the Arts Committee

11 April 2005

EXECUTIVE SUMMARY

Telstra welcomes the opportunity to provide this submission to the Inquiry by the Senate Environment, Communications, Information Technology and the Arts References Committee into the performance of the Australian telecommunications regulatory regime.

Overview of submission

The majority of Australia's current telecommunications regulatory regime was enacted in 1997, some 8 years ago, with a view to promoting competition in Australia's newly deregulated telecommunications markets. Australia's telecommunications markets are highly competitive. There are over 150 licensed carriers, four mobile networks and almost 700 internet service providers, not to mention a mature wholesale access market. Moreover, many of Telstra's competitors are large companies which bring to bear their significant experience in overseas markets and have had the opportunity to generate increasing profits in the Australian market.

As competition has developed and Australia's telecommunications markets have matured, so many elements of the 1997 regime have become increasingly outdated. The benefits of a more interventionist approach have reduced, while the costs and risks have increased.

Response to each of the Terms of Reference

Telstra's response to each of the eleven terms of reference of the present Inquiry is as follows, noting that some of the terms of reference raise overlapping issues:

1. *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:*

    - Part XIB was enacted some eight years ago as a transitional regulatory measure while competition developed. The Explanatory Memorandum in 1996 commented "*Part XIB will apply for the period from 1 July 1997 until some future review determines that competition is sufficiently established under that Part or some provisions of that Part are no longer needed*". The Minister was required by section 151CN of the Act to review whether Part XIB should be repealed before 1 July 2000, indicating Part XIB was only ever intended to have a limited, short-term, transitional application.

    - Following a review in 2001, the Productivity Commission initially recommended that Part XIB should be repealed consistent with the legislative intent. Given this recommendation proved controversial, the Productivity Commission subsequently proposed amendments to Part XIB, but still strongly emphasised that Part XIB "*should only be a transitional measure, it should be further reviewed in three to five years*".

    - Over the subsequent 4 years, significant competitive market entry has continued to occur. Australia's telecommunications markets are now highly competitive. In those markets in which competition may not be sufficiently

mature, an array of other regulatory instruments exist that render Part XIB redundant.

2. *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:*

- In practice, in setting access prices, the ACCC has regularly failed to recognise the efficiently incurred costs of providing access to declared services. As a result, infrastructure owners are unable to be assured of secure sustainable returns on their investment.

- Telstra has concerns about the manner in which the ACCC has exercised its discretion. There is perhaps no clearer example of the how the ACCC has exercised its discretion in a manner inconsistent with sound regulatory practice than the geographic exemption it granted in relation to the declaration of the local carriage service. The ACCC delayed the relaxation of the declaration of the local carriage service in metropolitan areas notwithstanding unequivocal evidence of existing significant and sustainable competition.

- In addition, Telstra has concerns with the infrastructure investment "safe harbours" in Part XIC, notably exemption requests and undertakings. These mechanisms fail to offer adequate regulatory protection to investors in new technologies. A key example in this regard is provided by the cable television digitisation exemption. Telstra applied for an exemption for digitisation and provided an extensive access undertaking in support. The ACCC accepted that undertaking and provided an exemption. Telstra proceeded to digitise its network at considerable cost. However, the ACCC's decision to grant an exemption was subsequently overturned on appeal. The problems evident in this case may have significant flow-on effects in relation to levels of confidence in investing in other services and technologies. In the face of such uncertainty, there is significant regulatory risk in infrastructure investment in Australia. Telstra therefore suggests that improvements are needed to the Part XIC regime to provide greater investor confidence in relation to new and emerging technologies.

3. *Whether there are any structural issues in the Australian telecommunications sector inhibiting the effectiveness of the current regulatory regime:*

- The Australian regulatory regime has evolved with specific regard to addressing pre-existing structural issues in the Australian telecommunications sector. For example, concerns over legacy ownership of last-mile infrastructure have been addressed by such measures as the Part XIC access regime. Concerns over vertical integration have been addressed by such measures as the competition provisions in Part XIB and more recently strengthened by the development of a long-term accounting separation and reporting regime.

- With a comprehensive and highly competitive access market, Telstra does not believe structural issues inhibit the development of competition in the telecommunications sector. However, there is a risk that the regulatory regime itself is now distorting effective investment in some areas, impeding long-term competition, as identified in the context of term of reference eight below.

- Some have suggested that physical structural separation of Telstra or divestiture of particular Telstra assets should occur to further promote industry competition. However, as the Government has expressly recognised, such structural reforms impose significant real costs that greatly exceed any likely potential resulting benefits. Furthermore, the same benefits can be easily achieved by other less-costly regulatory instruments and the Government has committed to explore the potential for greater transparency. In addition, the experiences with structural separation in other jurisdictions (e.g., Verizon in the US) have been, at best, mixed.

4. *Whether consumer protection safeguards in the current regime provide effective and comprehensive protection for users of services:*

- The consumer protection safeguards in the current regime are extensive. The telecommunications sector is one of the most heavily regulated sectors, from a consumer protection perspective, in Australia.

- Telstra submits that the current level of regulation is inconsistent in application. There is a significant degree of overlap of existing regulation imposing unnecessary costs. Telstra believes that existing regulation should be rationalised, with a view to ensuring consistency, symmetry and certainty.

5. *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:*

- As the Committee will be aware, Telstra made a comprehensive submission on these issues on 4 February 2005 in the context of the Committee's Inquiry into the Powers of Australia's Communications Regulators.

- Telstra identified in its earlier submission that the existing powers of the ACMA (once created) and ACCC are already sufficient. The ACMA will have

ample powers to address technical issues. The ACCC already has ample powers to address competition issues.

- As Telstra identified in its earlier submission, the ACCC already has regulatory powers and functions greater than generic competition regulators in other comparable jurisdictions. Unlike other jurisdictions, the ACCC has a principal role in sectoral access regulation as well as generic competition regulation.

- Telstra is not aware of any resourcing issues which would prevent these regulators adequately performing their roles. Telstra understands that the ACCC and ACMA are, and will be, well resourced.

6. *The impact that the potential privatisation of Telstra would have on the effectiveness of the current regulatory regime:*

- Telstra believes that the issue of its current and future ownership has no bearing whatsoever on the effectiveness of the current regulatory regime. The current regulatory regime does not depend on Government ownership of Telstra for its effectiveness. There is no causal relationship between these issues and any suggestion to the contrary evidences a misunderstanding of the Australian regulatory regime.

7. *Whether the Universal Service Obligation 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:*

- Telstra supports the policy of the USO in relation to the provision of standard telephony services. The USO ensures that telephony services - standard telephones and payphones - are accessible to all Australians regardless of where they live and is the mechanism that funds fixed telephone services in areas of rural and remote Australia that would otherwise be unviable.

- While Telstra believes the USO is ensuring that all Australian's have access to reasonable telecommunications services, Telstra's concern remains with the manner in which the USO is funded. Telstra is continuing to under-recover its costs of providing service to rural areas. Notwithstanding complaints by some other industry participants at bearing the cost of social policy obligations, the current payments from the industry are not sufficient and Telstra continues to bear a disproportionate burden of these costs.

- If the USO is amended to increase the scope of services covered, the additional costs of rolling out such services in rural and remote areas of Australia may be very substantial. Much of this cost would never be recovered. Given that the USO is a Government social policy, any non-recoverable rollout costs should be appropriately funded from general taxation revenue or via consumer or industry levies, consistent with international best practice in relation to USO funding and the practice in almost every other industry subject to community service obligations.

8. Whether the current regulatory environment provides participants with adequate certainty to promote investment, most particularly in infrastructure such as optical fibre networks:

- During 2002, significant amendments were made to Part XIC to provide infrastructure owners with greater certainty so as to promote greater infrastructure investment. These amendments were commendable in principle. However, the administration of Part XIC still raises concerns and, in Telstra's view, has prevented the effective implementation of these amendments. Telstra's detailed comments in this regard are addressed in relation to term of reference two of this Inquiry.

9. Whether the current regime promotes the emergence of innovative technologies:

- The current regulatory regime has a high degree of technological neutrality. This is generally commendable, promoting the emergence of innovative technologies and ensuring that regulation, properly applied, is readily adaptable to changing technologies. However, some key refinements to the current regulatory regime may be required in light of some of the more innovative recent technologies such as IP telephony.

- As Telstra has recently indicated in submissions to the ACA, a number of critical definitions in the Australian telecommunications regulatory framework were developed in the context of a dedicated hierarchical PSTN. These definitions apply somewhat uneasily to new technologies such as IP telephony, raising issues as to which regulatory obligations should apply in the long term. Regulatory touchstones such as access to emergency services will remain important for consumers no matter what the underlying technology that is used for making telephone calls. However, Telstra recognises that there is a need for a careful review by policy-makers of the current regulatory framework in light of such technologies to ensure a consistent approach and to avoid impeding the adoption of new technologies.

10. 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:

- The Australian Government has international obligations in the context of the World Trade Organisation agreements and its more recent Free Trade Agreements that crystallise the international consensus on best practice in relation to telecommunications regulation. These obligations provide useful guidance as to the appropriate level of sectoral regulation in the Australian telecommunications sector.

- However, the scale and scope of regulation currently present in Australia is now excessive by international standards in relation to the level of competition in Australian telecommunications markets and should be updated. International best practice supports a level of regulation closely tailored to the level of competition and directed at instances of manifest market failure. As competition develops, regulation should be reduced

commensurately. Australia has not properly adjusted its regulation to reflect the development of competition.

11. *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:*

- In Telstra's view, the performance of Australia's regulatory regime is hindered by the continued existence of Part XIB, rather than improved by it. In its 2001 review, the Productivity Commission identified a number of concerns with Part XIB. Many of these concerns remain and are highlighted in the body of Telstra's submission.

- In Telstra's view, the administration of Part XIC by the ACCC has focussed too much on promoting short-term competitive entry, via lower access prices, without adequately addressing the long-term adverse impact of such access pricing on the incentives for long-term infrastructure investment. Telstra suggests that a reconsideration of the balance adopted by the ACCC in the application of Part XIC may be appropriate given that most markets are subject to significant and sustainable competition. Telstra's concerns and suggestions are highlighted in the body of this submission.

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TABLE OF CONTENTS

1 SUBSTANTIAL BENEFITS HAVE ARISEN FROM TELECOMMUNICATIONS SECTOR DEREGULATION OVER THE LAST 15 YEARS - ANY REGULATORY PROPOSALS SHOULD BE VIEWED IN THE CONTEXT OF THAT DEREGULATORY APPROACH

1.1 Australia's telecommunications regulatory regime

Telstra believes that the starting point for this Inquiry should be to recognise two key issues. First, the critical importance of telecommunications to the Australian economy. Second, the substantial positive impact of sectoral *deregulation* on the performance of Australia's telecommunications markets over the last 15 years.

- As a geographically vast country with a highly dispersed population, located at a great distance from its trading partners, Australia depends heavily on the quality, efficiency and innovativeness of its telecommunications system. Australians stand to gain significantly from an environment that promotes the prompt adoption and investment in new telecommunications technologies and their resulting benefits.

- The deregulation of Australia's telecommunications sector has occurred in two distinct transitional phases, reflecting a progressive reduction in the level of Government regulation. Importantly, Telstra emphasises that it is telecommunications *deregulation*, rather than regulation, that principally facilitated this transitional process to facilitate competition.

Telstra would be concerned if this Inquiry were to recommend an increase to the level of Australian telecommunications regulation, effectively reversing this deregulatory trend, particularly given the critical importance of the telecommunications sector.

1.2 The first transitional phase (1991 to 1997) – from monopoly to duopoly

Australia was an early leader in opening its telecommunications sector to competition. Australia's telecommunications reforms were partly motivated by a concern that Australia was lagging behind other economies. As identified by the OECD at page 78 of its recent *OECD Economic Survey Australia* dated December 2004 ("**OECD 2004 Report**"), Australia had recognised by 1991 that excessive government intervention was a key factor underlying Australia's poor economic performance.

Aside from some competitive entry possibilities in the late 1980s, the process of telecommunications liberalisation largely commenced with the enactment of the *Telecommunications Act 1991*. This legislation was intended to support and regulate the initial phase of competition by creating a managed duopoly regime. The regime was administered by a separate industry regulatory agency known as AUSTEL.

Between 1991 and 1997, the primary goal of the regime was to nurture Optus and Vodafone, as duopoly franchisees in the fixed and mobile markets, to achieve status as fully-fledged competitors to Telstra. For six years, the regime operated to actively favour and promote Optus and Vodafone as principal beneficiaries of regulatory intervention. The stated goal of the regime was to initiate the first stage of a

transition from Australia's highly managed telecommunications market towards one more reliant on competition policy.

However, it is worth emphasising the wide range of regulatory instruments, and their overly intrusive nature, to this end. Through controls over Telstra's ability to offer selective discounts, Telstra's capacity to compete with Optus and Vodafone at the retail level was deliberately circumscribed.

The 1991 regulatory regime was particularly prescriptive in the restrictions it imposed on Telstra's conduct. The arrangements encouraged the emergence of a class of resale competition that was based, in essence, on arbitrage between regulated wholesale prices and quasi-regulated retail prices. This form of competition, in itself, did not meet the policy aim of "sustainability".

1.3 A second transitional phase (1997 to now) – from duopoly to newly deregulated market

The enactment of the *Telecommunications Act 1997*, supported by simultaneous transitional amendments to the *Trade Practices Act 1974*, constituted the next phase in the process of Australian telecommunications sector deregulation. From 1 July 1997, most regulatory impediments to competitive entry were removed and policy makers sought to substitute generic competition law for telecommunications-specific regulation. Consistent with the policy objective of achieving the earliest maximum reliance on generic regulatory instruments and institutions, the key competition regulatory functions for the industry were vested with the ACCC.

Importantly, the 1997 reforms were again premised on industry *deregulation*, not greater regulation. The benefits from the 1997 reforms principally flowed from its *deregulatory*, rather than its regulatory, aspects - as identified in detail below.

From 1997, the focus shifted to the more general objective of promoting market entry and competition. The *Trade Practices Act* was augmented with two telecommunications-specific sections that were intended to facilitate a transition to full market competition. Part XIB of the *Trade Practices Act* was enacted to supplement the generic competition rules in Part IV of the *Trade Practices Act* that deter anticompetitive behaviour. Part XIC of the *Trade Practices Act* was enacted to supplement the rules in Part IIIA of the *Trade Practices Act* so as to provide competitors with access to key telecommunications services. Part XIB, in particular, was expressed as transitional and short-term - a way-station along the road to the earliest possible and fullest reliance on the generic economy-wide provisions of the *Trade Practices Act*.

With the removal of governmental constraints to the roll-out of competitive infrastructure, new carriers were able to enter the market on an effectively unrestricted basis. Within 12 months, 13 additional carriers had been licensed. There was also a rapid increase in the number of service providers, rising to 878 within 2 years. The OECD 2004 Report (at page 110) comments that: "*The Government allowed full competition in services in the Telecommunications Act 1997, and there are currently around 100 carriers (companies who own specified infrastructure facilities) and 1,000 service providers.*"

Consistent with the deregulatory approach embodied in the 1997 legislation, industry self-regulation was also heavily promoted. Section 6 of the *Telecommunications Act 1997* included an express statement of regulatory policy, stating: "*The Parliament intends that telecommunications be regulated in a manner that...promotes the greatest practicable use of industry self-regulation...*". Part 6 of the *Telecommunications Act* therefore required and encouraged industry bodies to develop voluntary and mandatory codes of practice. These codes set out rules to govern the behaviour of the telecommunications industry, covering a range of consumer, network and operational issues. The aim of industry codes was to meet important policy objectives without imposing undue financial and administrative burdens on industry participants.

In summary, the key theme of the 1997 reforms was an emphasis on deregulation and minimising any need for regulatory intervention. However, transitional regulation was promulgated to promote the initial development of competition and greater market entry.

1.4 The benefits of telecommunications sector deregulation

Australia's current telecommunications regulatory regime was therefore enacted in 1997, some eight years ago, with a view to promoting competition in Australia's fledgling deregulated telecommunications markets. The migration from a more heavily regulated telecommunications sector in 1991-1996 to a more deregulated sector from 1997 has resulted in very significant benefits to the Australian economy.

The Australian Communications Authority (**ACA**) comments in its *Telecommunications Performance Report 2003-04* ("**ACA 2004 Report**") that in the 2003–04 financial year, the Australian economy was more than AU$10.4 billion larger in terms of total production than it would have been without the move to a less interventionist telecommunications regulatory regime from 1997.

By 2003–04, the ACA has identified that Australia's 1997 telecommunications reforms have resulted in:

- employment of around 30,000 additional employees in the Australian economy;
- private additional real consumption benefits of nearly $720 per household, or approximately AU$5.5 billion aggregated over all households;
- benefits to small business in excess of AU$2.1 billion; and
- the output from the telecommunications industry being around 96% greater than if the 1997 telecommunications reforms had not occurred.

The ACA has indicated that, taking all increases together reveals that, on average, the welfare of Australian households is approximately $924 per household higher by 2003–04 than it would have been without the 1997 telecommunications reforms. The ACA has indicated that this equated to a net benefit to Australian consumers of around AU$7.06 billion by 2003–04.

Some of these gains could be put at risk if a greater level of regulatory burden is imposed on providers. Conversely, even larger gains could be expected over time if deregulation continues.

2 AS A RESULT OF INDUSTRY DEREGULATION, AUSTRALIAN TELECOMMUNICATIONS MARKETS ARE NOW HIGHLY COMPETITIVE BY WORLD STANDARDS

2.1 Industry deregulation and transitional regulation has promoted competition

The deregulation of Australia's telecoms sector from 1997 has promoted significant market entry, leading to the development of significant and sustainable competition throughout Australia's telecommunications markets. Consider the following:

- in real terms the average price paid by consumers for PSTN and mobile telecommunications has fallen by 20 per cent;[1] and
- a wide range of new products are increasingly used, most notably in data and mobile services, but even at the level of fixed voice telephony, enhanced telecommunications services such as voicemail, call-back, conference calling, personal numbering and intelligent call waiting have emerged, providing significant benefits to customers.

The extent and degree of competition have also increased. New competitors, technologies and service delivery possibilities have arisen and market entry and exit remain fluid:

- infrastructure investment in new networks continues with the introduction of a third generation mobile network (with further deployment foreshadowed), the deployment of regional wireless access networks and the upgrading of existing networks. Competitive investments in the customer access market and in technologies bypassing Telstra's copper-based local loop are increasingly common in the Australian telecommunications landscape;
- competition is intense in the markets for fixed voice telephony, from local calls to national long distance and international calls;
- there are now four major mobile network carriers that operate six networks; and
- in the growing data and Internet services markets, many service providers, including some large market players, are aggressively competing for customers.

Australia's telecommunications markets are competitive, with vigorous rivalry characterising all key industry segments and with an established presence by many of the world's major telecommunications providers. Telstra faces well-placed, robust, competitors in all key market segments both by virtue of a very competitive wholesale access regime and in some markets, significant infrastructure competition.

Like Telstra, most of these competitors are vertically and horizontally integrated; many are affiliates of powerful corporate multinationals far larger than Telstra itself.

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[1] ACCC Telecommunications Reports 2002-03, Report 2, at page 66.

These affiliates can draw on the extensive resources of those multinational entities when competing in the Australian market.[2]

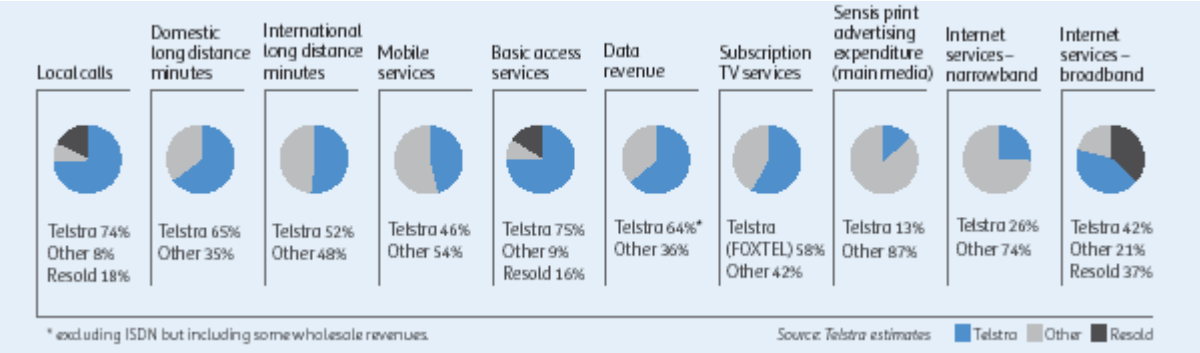
A number of Telstra's major competitors have access to unique arrangements that provide them with a competitive edge, including lower costs than Telstra, unique differentiating content and/or a powerful international brand. Multinationals such as Vodafone, SingTel Optus and Hutchison can typically source mobile handsets, infrastructure and content at a lower cost than Telstra from international vendors by leveraging their greater bargaining and purchasing power as multinationals in international markets.

As a result, the range of available services has expanded and there has been substantial innovation in price and service packages. Telstra has consistently experienced fierce competition and loss of market share. These features are consistent with the concept of highly competitive and contestable markets.

Indeed, Telstra is continuing to lose market share as a result of fierce and successful competition. It is noteworthy that Telstra's market share is currently lowest in many of the newer, most attractive, and often most strategically important markets.

Telstra's market share in the range of key markets is illustrated by the following diagram based on Telstra's estimate of market shares as at 30 June 2004. This diagram is extracted from page 9 of Telstra's 2004 Annual Review and is summarised on page 38 of Telstra's 2004 Annual Report.

Telstra's Market Share



That said, it should be noted that focus on Telstra's market share alone is not an appropriate measure or reflection of the state of competition in Australian telecommunications markets. Focus on Telstra's static market share ignores the dynamic trends in the telecommunications industry and fails to take into account other equally, if not more important indicators of competition such as reductions in prices and consumer outcomes noted above. Stable market shares are not an indicator of market failure – it may be that Telstra is responding to competitive forces by successfully maintaining customers in a highly competitive market. Commentators sometimes highlight a perceived lack of infrastructure competition but ignore Australia's highly favourable access regime and the competition this

[2] For example, between March 2003 and March 2004, Singtel Optus' profits increased by twenty fold: see Singtel Optus Annual Report, to financial year March 2004.

drives at the retail layer and the competition that is increasingly coming from wireless and other new network technologies.

It is also important to note that effective competition cannot mean that Telstra's market share will fall forever, or that the rate of price declines will continue. This focus on outcomes in traditional markets also misses the larger picture. Next generation technologies are altering the structure of the market for communications services, potentially reducing end-users' dependence on the fixed-line network and thereby making the focus on traditional markets increasingly irrelevant.

Further, many of the markets in which competition is most vigorous are dynamic, changing and relatively immature. As noted, Telstra's market share is generally very low in these markets. Imposing regulation in such markets has the potential to lead to regulatory error; and to stymie rather than promote the growth of sustainable competition in these markets. Moreover, there is no reason to believe that regulators are better informed than these markets about the appropriate way in which competition should evolve.

2.2 Productivity Commission's earlier conclusions in 2001

Telstra believes that a useful independent point of comparison for an assessment of the level of competition in Australia's telecommunications markets, beyond market shares alone, is provided by the conclusions of the Productivity Commission in 2001.

The Productivity Commission concluded in its Final Report (at page 99) that the following markets are among the more competitive Australian telecommunications markets:

- mobile services (the Productivity Commission commented "*the mobile services market appears to exhibit characteristics of an effectively competitive market*");
- Internet services (the Productivity Commission quoted the ACA's analysis that "*the significant variation in the size of ISPs and the great number of ISPs suggests a healthy, competitive market*");
- data services; and
- long distance services.

However, the Productivity Commission concluded in 2001 that local access services and local telephony services were still areas where effective competition was less developed. In 2001, Telstra's market shares were identified at around 83% and 95% respectively, which can be compared to the lower market shares in 2004 identified above.

- Telstra notes that competition in the local telephony service market has developed significantly since the Productivity Commission's 2001 conclusions. This market has been subject to direct regulation under Part XIC of the *Trade Practices Act*. In addition, it has been the subject of very

intense competition, resulting in unique offers and substantial discounting. Telstra's market share has decreased substantially.

- Likewise, Telstra remains subject to price controls in relation to local access services which heavily constrain any Telstra market power. Telstra notes that this segment of the telecommunications sector may continue to remain concentrated in the short-term given significant capital requirements as well as economies of scale and scope. However, this condition is not likely to persist in the long-run, particularly with technological innovation and the roll-out of competitive wireless and wireline infrastructure. Even for local access services, there is mounting evidence that significant competition is developing. It is though, worth noting, that the continuation of price control regulation in markets in which margins are already low, declining or non-existent, may deter further competitive entry. As a result, price control regulation may, paradoxically, perpetuate the need for ongoing price control regulation.

2.3 Australia's telecoms markets are now highly competitive

Evidence of substantial entry, significant reductions in Telstra's market shares for all services, across the board price declines, and high-levels of customer churn provide potent testimony that competition is vigorous in virtually all service markets.

The current level of competition in Australia's telecommunications markets is also illustrated by the following indicative statistics in the fixed, mobile and data industry segments.

- Fixed voice (local, long-distance and basic access)
    - Competition has significantly eroded Telstra's market share for national long distance and international telephone services.
    - Telstra also faces infrastructure competition in basic access and local call services in the central business districts of the major capital cities and major metropolitan areas (being those areas where it is economic for competitive infrastructure to be rolled out).
    - The level of competition in the wholesale transmission market, in particular, led the ACCC in April 2004 to further de-regulate the inter-capital routes and 14 major capital-to-regional routes.
    - Between 1997-98 and 2002-03 the average price (in real terms) paid for local calls decreased by 37.1%, national long distance calls by 30.9% and 61.7% for international calls.
    - Over the same period, the average price paid for a basket of PSTN services by consumers decreased in real terms by about 20%.
    - There is now high access-based competition in the customer access market: almost 18% of Telstra's own access lines are resold by competitors. There is also an increasing number of network-based

competitors, including Optus' HFC network, TransACT and Neighbourhood Cable.

- Mobile services
  - The mobile services market is one of the most competitive telecommunications markets in Australia. Four mobile network carriers operate six networks. When resellers and MVNOs are included, there are currently 24 mobile phone services providers in Australia.
  - Introduced in the early 1990s, mobile telecommunications has reached a penetration rate of approximately 80% of the total population as at 30 June 2004.
  - The average price paid for mobile services has declined in real terms by 24% between 1997-98 and 2002-03.
  - Telstra's market share in mobile services has continued to decline and is now less than 46%.
- Internet & data services
  - The Australian data market is intensely competitive, with a number of service providers in a range of categories from network, ISPs, international and Managed Service Providers (MSPs) offering a range of domestic and international services.
  - Competition is particularly intense in new growth areas based on DSL, Ethernet or IP-based solutions
  - As at December 2004, total broadband take-up was 1,548,300, which represents a growth rate of 121.6% since December 2003.
  - Competition in the data and Internet services market has resulted in significant benefits, including increased on-line participation; lower prices; higher consumption of data services; and higher quality of services.
  - At the end of September 2004, there were 687 internet service providers supplying internet access to 5.7 million active access subscribers. There were 10 internet service providers with more than 100,000 subscribers.[3]
  - Telstra's market share in retail narrowband and broadband Internet access is 26% and 42% respectively.

In summary, Australia's telecommunications markets are highly competitive.

[3] Australian Bureau of Statistics (2005), Internet Activity Australia.

3 ELEMENTS OF THE 1997 REGIME ARE NOW OUTDATED - A LESS INTERVENTIONIST APPROACH WOULD RECOGNISE THE DEVELOPMENT OF SIGNIFICANT COMPETITION

3.1 Elements of the 1997 regime are now outdated - further deregulation is required

As competition has developed and Australia's telecommunications markets have matured, so many elements of the 1997 regime have become increasingly outdated. The benefits of a more interventionist approach have reduced, while the costs and risks have increased.

The adoption of the 1997 regime in Australia reflected a global paradigm shift in regulatory policy. Markets are better than regulators or governments at guiding the industry to efficient outcomes and at injecting competitive forces and discipline into industry behaviour. As the transition to effective competition takes root and sustainable competition is assured, the telecommunications industry should be further deregulated and the costly apparatus of direct regulatory oversight further dismantled. Approaching eight years after the introduction of the 1997 regime, it is now appropriate to revisit the regulatory framework to assess its suitability, recognising that most markets are now subject to significant and sustainable competition; and that, as a matter of sound economic policy, regulation should only apply where there is manifest market failure.

Australian telecommunications policy has (for over a decade now) been based on two fundamental principles:

- first, minimalist sectoral telecommunications regulation can, and should, be used to assist the industry's transition to competition; and
- second, as competition becomes established, such minimalist regulation should become proportionately less intrusive and should be replaced by a reliance on generic competition laws.

Furthermore, at each stage in the process of telecommunications sector deregulation it has been recognised that as successive milestones are reached in the development of competition, it is important to move to less intrusive approaches to regulation. Two factors underpin this recognition.

- Excessive regulation may impede market efficiency and competition: Once competition is established it is naturally a vigorous force that needs little further protection above and beyond that provided by generic competition law. A regulatory regime that purports to protect competition as if it were highly vulnerable, risks inhibiting *bona fide* competitive conduct and suppressing the very vigour of competition that supports efficiency and innovation. As a result, once competition is well-established, regulatory support measures need to be withdrawn as soon as possible, lest the industry, or some of its firms, become structurally reliant upon them.

  In its 2001 Final Report on *Telecommunications Competition Regulation*, the Productivity Commission made the following relevant recommendations (at

page 4), for example, setting out its vision for a telecommunications regulatory regime that would best meet Australia's interests:

> "Competition policy should be aimed at securing efficient outcomes — such as consumer choice, efficient production and innovation — rather than competition in its own right or the protection of particular competitors. Social objectives are better targeted by other policy instruments.
>
> "Regulation should apply only to areas where there are clearly identified problems and where regulation is an effective remedy. It should be transparent, predictable, accountable, consistent, and fair."

The Productivity Commission also identified the dangers of excessive regulation in the following terms (at page 21):

> "Even if it were accepted that market power is present and causes large economic costs, this is not sufficient grounds for government intervention. The appropriate test of any intervention is how outcomes compare with alternative interventions, including the option of doing nothing. This takes into account the risks of regulatory failure and the inevitable imperfections that accompany regulations...
>
> Regulatory errors... mean that regulation can produce distortions in investment, innovation and prices. Perversely, the imperfections inherent in competition regulation have the potential to swamp their benefits, implying that it can, in some cases, be best to use regulations sparingly, even if that leaves some market power unchecked."

- Excessive regulation creates scope for costly regulatory error: Regulators, no matter how scrupulous they are in the pursuit of the regime's goals, face a high degree of risk in attempting to second-guess the outcomes that market forces would otherwise have generated. Avoiding the costs that potential errors would otherwise impose on the community justifies a move to less intrusive regulatory arrangements as soon as market developments permit. As the Productivity Commission's Office of Regulation Review has noted:

> "While some regulation is necessary and beneficial, there are some cases where it may not be so or where it could be better designed. Regulation should not only be effective, but should also be the most efficient means for achieving relevant policy objectives.... Determining whether regulation meets the dual goals of 'effectiveness' and 'efficiency' requires a structured cost-benefit approach to policy development. The relevant problem to be addressed and subsequent policy objective should be identified as a first step in the policy development process, followed by consideration of a range of options (including no action) for achieving the objective. The benefits of any regulation to the community should outweigh the costs."

The Productivity Commission also specifically commented on this issue in its Final Report into *Telecommunications Competition Regulation* in the following terms:

> "Regulatory interventions are not costless — a point made by several participants (for example, IPA sub. 20, p. 3). Apart from their obvious compliance costs, they can also produce their own set of inefficiencies because they involve the use of imperfect instruments by regulators, devised under circumstances of asymmetric information and uncertainty. They impose rules on markets that can 'have chilling effects on entrepreneurship and innovation' (Yarrow 2000, p. 3).

> Further, regulators may be captured by various interests and have objectives of their own. Sidak and Spulber (1998, p. 29) argue that regulators, like the businesses they regulate, are not angels, but can make errors and behave opportunistically and partially. And unlike the businesses being regulated, a regulator or competition body has more complex governance arrangements, and objective measurement of its success is difficult."

As a result, each phase in the development of Australian telecommunications policy has reflected the objectives of a move from more intrusive to less intrusive regulatory arrangements. These phases have broadly paralleled the evolution of the competitive market as identified in section 1 of this submission.

3.2 A third transitional stage - a less interventionist approach is now appropriate

Economists generally agree that markets, rather than regulations, provide the most effective means of delivering to consumers the products and services they want and provide proper signals for investment decisions by market participants - hence regulation should be reduced where market failures due to excessive market power have been addressed. In this manner, as competition increases, the benefits of sectoral regulation reduce while the costs and risks associated with its continued existence increase.

Furthermore, sector-specific regulation tends to exacerbate regulatory burdens and has its own costs and risks. Sectoral regulation should therefore be wound back if the competitive risks are small or can be readily handled by generic competition laws. Such an approach is consistent with incremental deregulation of the telecommunications industry as competition increases, reflecting an inverse correlation between the degree of regulation and the degree of competition.

Such an approach is also consistent with the Competition Principles Agreement that binds the Commonwealth. The Competition Principles Agreement places the onus of demonstrating the public benefit from regulation with those who seek to maintain regulations in place.

To be clear, Telstra is not advocating no regulation. Australia has international obligations in relation to the domestic regulation of the Australian telecommunications sector. However, despite some deregulation over the years, the telecommunications sector still remains one of the most heavily regulated industries in Australia, even when compared to recently deregulated markets such as airlines. The degree of regulation has been further increased in recent years, potentially defeating the initial deregulatory intent. As a result, Telstra and most other firms in the industry are subject to an ever-increasing patchwork of extensive and costly *ad hoc* regulation.

Telstra submits that a less interventionist approach is now more appropriate for the Australian telecommunications sector. Such an approach should appropriately recognise that most Australian telecommunications markets are now subject to significant and sustainable competition.

4 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

4.1 Parliament expressly intended that Part XIB would only have transitional application

The market conduct arrangements set out in Part XIB are the legacy of a compromise that was struck at the end of the duopoly period. As identified earlier in this submission, the 1991 legislation that defined the framework for the duopoly imposed a number of relatively prescriptive controls on conduct by carriers generally, and on dominant carriers in particular. As with most forms of regulation, these provisions had beneficiaries with vested interests, in this case mainly in the form of Telstra's competitors. As a result, there was strong opposition to simple repeal. Part XIB was the transitional policy compromise.

Part XIB of the *Trade Practices Act* was therefore enacted some eight years ago as a transitional regulatory measure while competition developed. Importantly, Part XIB was never intended to be permanent. Rather, Part XIB was only ever intended as a transitional measure to assist the telecommunications sector during the early years of deregulation. The intent was always that Part XIB would be repealed, followed by greater reliance on the generic economy-wide competition laws. The Explanatory Memorandum accompanying the 1991 amendments expressly commented:

> "It is intended that competition rules for telecommunications will eventually be aligned, to the fullest extent practicable, with general trade practices law. Part XIB will apply for the period from 1 July 1997 until some future review determines that competition is sufficiently established that the Part or some provisions of the Part are no longer needed."

Furthermore, section 151CN was inserted into Part XIB to require the Minister to cause a review to be conducted of Part XIB of the *Trade Practices Act* before 1 July 2000. Section 151CN(2) stated:

> "In conducting the review, consideration must be given to the question whether any or all of the provisions of this Part should be repealed or amended".

The Minister was required to prepare a report of the review and table copies before each House of Parliament.

The clear intent, as evidenced by the Explanatory Memorandum and the timing set out within section 151CN, was that Part XIB would be a short-term transitional measure that would be repealed (in whole or in part) once sufficient competition had developed.

Consistent with Parliament's original intent, Telstra submits that the relevant question for any current review of the performance of Australian telecommunications regulation should be whether competition is now sufficiently established in the Australian telecommunications sector that Part XIB (or some provisions of Part XIB) are no longer required.

4.2 Productivity Commission initially recommended in 2001 that Part XIB should be repealed

Following a review in 2001, the Productivity Commission expressed a number of concerns with Part XIB and considered two options: repeal of Part XIB; or amendment of Part XIB to modify its undesirable features. The Productivity Commission initially recommended in its Draft Report (Recommendation 5.1) that Part XIB should be repealed:

> "Draft Recommendation 5.1: The Commission recommends that the anti-competitive conduct provisions of Part XIB of the *Trade Practices Act 1974* be repealed."

The Productivity Commission noted in its Draft Report (at page 5.40) that the following concerns supported the repeal of Part XIB. Telstra notes that all of these concerns continue to apply today:

- enhanced opportunity for regulatory error and overreach;
- many of the cases considered under Part XIB have been minor - not usually involving circumstances where lack of speedy regulatory action could lead to market foreclosure;
- relevant action can be pursued under Part IV (including the seeking of injunctions by firms that consider themselves adversely affected by the anti-competitive conduct of others), Part XIC or in a number of other ways;
- progress under Part XIC, together with further improvements to the access provisions reduce the need for specific anti-competitive conduct regulation in telecommunications markets;
- a strong case exists that the issues under Part XIB for which competition notices have been issued would more appropriately have been dealt with under other provisions of the *Trade Practices Act*, particularly Part IV;
- telecommunications competition has increased substantially since 1997 and should be more self-sustaining in the longer term, even with less regulation;
- given the other remedies available, removal of the anti-competitive conduct provisions of Part XIB is likely to have no significant effect on competition; and
- in the Productivity Commission's view, repeal of the anti-competitive conduct provisions of Part XIB would not be inconsistent with Australia's international obligations.

However, in its Final Report, the Productivity Commission altered its recommendation for repeal of Part XIB. The Productivity Commission noted that its recommendation for repeal had attracted widespread industry criticism and strong opposition from the ACCC. The Productivity Commission instead adopted its second option and proposed amendments to Part XIB, but with a number of reservations and conditions.

In its Final Report, the Productivity Commission strongly emphasised that Part XIB should only be a transitional measure that should be further reviewed in three to five years. The Productivity Commission indicated that if continued problems were experienced with Part XIB, then a review should occur after 3 years (i.e., September 2004). However, if no problems were experienced, the review should occur after 5 years (i.e., September 2006):

> "In introducing Part XIB, the Government envisaged that it would be transitional in nature pending the establishment of competition in the telecommunications sector. Certainly, if sustainable competition develops further, the justification for special anti-competitive conduct provisions would lessen. This is because such competition will reduce the scope for anti-competitive conduct in the first place and, in the second, reduce the need for speed in dealing with it.
>
> For this reason, the Commission considers that Part XIB should be again reviewed, within three to five years. Such a review could also take account of the impact of continuing convergence on the need for sector-specific anti-competitive conduct regulation (sub. DR114, p. 11).
>
> The precise timing would depend partly on the pace at which sustainable competition develops in telecommunications. As well, it should depend partly on the record of the ACCC in dealing with anti-competitive conduct matters. As discussed above, so far the ACCC appears to have been cautious in anti-competitive conduct investigations and, based on the limited information publicly available, its investigations have merit. However, the proposed appeal mechanism as well as the requirement for public reporting should provide a better basis for judgment on the appropriateness of the ACCC's investigations and conclusions. If problems become evident, the proposed review could be conducted earlier rather than later. If, on the other hand, the ACCC's actions are largely confirmed, the review could be held at the end of the suggested period."

The Productivity Commission summarised its conclusion on Part XIB as follows:

> "On balance, the Commission supports retention of Part XIB pending the development of more sustainable competition in telecommunications. This support is conditional on the introduction of an appeal mechanism intended to enhance procedural fairness. As Part XIB should only be a transitional measure, it should be further reviewed in three to five years."

4.3 Competitive entry and other obligations have rendered Part XIB redundant

As identified in section two of this submission, the state of competition in the telecommunications industry has changed dramatically since July 1997 when Part XIB was enacted. Over the subsequent eight years, significant competitive market entry has occurred. Competition has continued to intensify in the four years since the Productivity Commission last considered Part XIB and made its recommendations. Australia's telecommunications markets are now highly competitive.

Furthermore, in those markets in which competition may not be sufficiently mature an array of other regulatory instruments exist such that Part XIB is effectively redundant. Telstra also refers to its comments in relation to Part XIB in section 11 of this submission in which Telstra identifies that there have been continued problems arising from Part XIB.

Telstra submits that competition regulation of the telecommunications industry should be moved into line with Australia's generic competition laws as was initially intended. Given that the penalties under Part IV of the Trade Practices Act are now

being dramatically increased (including penalties based on turnover and criminal penalties), it is likely that the deterrent effect of Part IV will be significantly greater than the effect of Part XIB in any event.

5 WHETHER PART XIC OF THE TRADE PRACTICES ACT 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

5.1 Part XIC contains serious flaws

Three issues are of particular concern to Telstra:

- Regulated access prices have been set too low, deterring investment by access seekers: Telstra has particular concerns regarding access pricing, namely the balance adopted by the ACCC between the interests of access seekers and infrastructure owners inherent within access pricing;

- The timeliness of the ACCC's assessment of undertakings: The ACCC's assessment of undertakings has generally taken too long; and

- Difficulties with the infrastructure investment "safe-harbours". Telstra has particular concerns with the administration of the infrastructure investment "safe-harbours" within Part XIC, notably in relation to exemption requests and access undertakings.

5.2 Short-term competition versus long-term investment

Telstra is concerned that the ACCC has been preoccupied with promoting short-term competition without properly focussing on the need to promote long-term investment. By promoting short-term competition rather than sustainable investment, the ACCC is likely to perpetuate the need for ongoing access regulation. These concerns seem to be reflected in comments by the ACCC itself, with the current Chairman recently noting that:

> "... the [telecommunications industry] continues to be heavily dependent on access and resale arrangements with competitors simply buying space on the Telstra network rather than building their own facilities and offering different products and better performance".[4]

Access undertakings were to be an important element in the Part XIC access regime as a basis for increasing investment certainty. In introducing the 1997 legislation, the Minister observed that:

> "The Government will also be encouraging the larger access providers to submit an access undertaking for ACCC acceptance. This would both improve the certainty surrounding the terms and conditions on which those persons must comply with the access obligations and provide increased certainty for access seekers."

However, as noted, in practice, the difficulties associated with the access undertaking process tend to limit its effective use.

As a result of its 2000 and 2001 review, the Productivity Commission made a series of recommendations with a view to improving the operation of Part XIC. The

[4] Graeme Samuel, ATUG Conference, 10th March 2005.

Productivity Commission commented in its 2001 Final Report, for example (at pages 255, 285 and 294):

> "A key policy concern is that Australia has appropriate investment in telecommunications facilities — reflecting the increasing importance of broadband and other telecommunications services to the future growth of the Australian economy and our standard of living (chapter 1). Accordingly, it is important to ensure that the access regime does not overly weaken the incentives for access providers to invest in core infrastructure."
>
> "Notwithstanding a tighter set of declaration criteria, mandated access still presents formidable regulatory risks to investors. Telecommunications technology and markets are rapidly moving and very risky (chapter 1). If firms consider that regulators are fallible and may have difficulty separating rewards for risk from monopoly returns, then this has adverse consequences for investment. Access pricing that fully recognises regulatory uncertainty and the scope for regulatory error may be a remedy (chapter 11) — but this may be hard to implement and may lack ex ante credibility. Access holidays, regulatory compacts and other ex ante options may provide greater certainty for carriers prior to making their investments, but they too have some practical implementation problems.
>
> The parallel inquiry into Part IIIA has recommended that the Commonwealth Government should through COAG initiate a process to refine mechanisms for dealing with the problem (Productivity Commission 2001c). Such a process would provide a basis for also determining approaches that might also be used in Part XIC. No separate recommendation is required in this inquiry."
>
> "For a carrier making a new investment, the risk of future declaration - with regulated access prices - may lead to the delay or termination of the planned investment. This is because access regimes may truncate the returns from risky investments. The Commission has proposed a number of options for dealing with this problem, such as binding rulings and regulatory contracts that provide immunity from declaration. The Commission's parallel inquiry into Part IIIA has recommended a process for refining the options that should be employed, and the outcome of that process should also be incorporated into Part XIC."

Telstra generally agrees with these conclusions and recommendations. Telstra notes, however, that while some of the Productivity Commission's recommendations were adopted, many were not.

5.3 Undertakings and the timeliness of decision-making

Despite changes in recent years to the access regime to improve the timeliness of the undertaking assessment process, the ACCC's assessment of undertakings has proved not to be timely.

Consider the first two price-related undertakings Telstra lodged with the ACCC in relation to PSTN originating and terminating access shortly after the commencement of the 1997 regime. This proved to be an enormously time-consuming task for Telstra, the ACCC and other interested parties involved in the assessment process.

The Commission took nearly two years to assess Telstra's first PSTN undertaking and 11 months to assess the revised undertaking lodged by Telstra. Indeed, by the time the Commission released its final assessment of Telstra's first PSTN undertaking, the price terms and conditions had already lapsed. Similarly, for the second PSTN undertaking the first year of proposed charges had lapsed by the time the Commission finalised its assessment.

While it might have been possible to attribute delays with the ACCC's assessment of Telstra's original PSTN undertaking to the ACCC's unfamiliarity with the access regime, such regulatory delays have continued in relation to other undertakings lodged by Telstra. Further, as seen below, there is some evidence that Singtel Optus, most likely the principal beneficiary of any reduction in access prices, is already enjoying the benefits of the rates posted by Telstra in its undertaking for the Unconditioned Local Loop Service

Telstra lodged its core service undertakings with the ACCC in January 2003, specifying the terms and conditions upon which it undertook to meet its standard access obligations to supply the domestic PSTN originating and terminating access services, the Unconditioned Local Loop Service and the Local Carriage Service for 2002-03, 2003-04 and 2004-05.

In October 2003, the ACCC released model price terms and conditions for these core service undertakings. In November 2003, Telstra provided revised undertakings for the core services (replacing those lodged by Telstra in January 2003), which mirrored the ACCC's recommended prices.

Despite the alignment of Telstra's prices with the ACCC's recommended rates, it was not until nearly one year later (October 2004) that the ACCC released its draft decision proposing rejection of Telstra's undertaking with respect to the Unconditioned Local Loop Service and gave some qualified acceptance of Telstra's undertakings in relation to the domestic PSTN originating and terminating access services and the Local Carriage Service. In response to the draft report, Telstra withdrew its Unconditioned Local Loop Service undertaking. It submitted a new Unconditioned Local Loop Service undertaking, removing the price adjustment mechanism which the ACCC had indicated in their draft decision was the primary subject of concern.

In December 2004 the ACCC released a final decision reiterating its draft views on the Local Carriage Service and PSTN originating and terminating access services. The ACCC is still to release a decision in relation to Telstra's Unconditioned Local Loop Service. Meanwhile, Singtel Optus (which has publicly contended that Telstra's proposed rate for the Unconditioned Local Loop Service in metropolitan areas exceeds Telstra's efficiently incurred costs),[5] has, in a different context, publicly stated that its gross margin for voice and DSL services will leap from $15 to $45 if Telstra's Unconditioned Local Loop in metropolitan areas continues to be priced at Telstra's undertaking rate of $22.[6]

5.4 Investment safe-harbours

On 10 December 2002, Parliament enacted the *Telecommunications Competition Act 2002* which amended a range of existing telecommunications legislation. Relevantly, the Act sought to give effect to a number of recommendations of the

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5 See Singtel Optus submission to ACCC in relation to Telstra's Core Service Undertakings, at http://www.accc.gov.au

6 See Singtel Optus *Consumer& Multimedia Briefing to Investors*, Scott Lorson, 5th April 2005, Investor Presentation, at http://www.optus.com.au

Productivity Commission in relation to the Part XIC access regime with a view to promoting greater investment certainty.

In particular, the Act sought to encourage further investment in telecommunications infrastructure by providing mechanisms to enable potential investors to obtain up-front certainty as to the access requirements that would be imposed on them. These mechanisms included:

- exemption procedure: a carrier may apply for an exemption from the standard access obligations and the ACCC may grant this, subject to conditions and limitations, if the ACCC is satisfied that the exemption promotes the long term interests of end users;
- special access undertaking (SAU) procedure: a carrier may offer an SAU to the ACCC on various terms and conditions. The ACCC will decide whether to accept the SAU based on whether the terms and conditions are reasonable and consistent with obligations to provide access.

In this manner, significant amendments have been made to Part XIC to provide infrastructure owners with greater certainty so as to promote greater infrastructure investment. Telstra believes these amendments are useful in principle.

However, the administration of Part XIC still raises concerns and, in Telstra's view, has prevented the effective implementation of these amendments. This is illustrated by Telstra and Foxtel's application for an exemption order from the ACCC in relation to the digitisation of the HFC cable television network. An exemption order was granted by the ACCC on the basis of an extensive access undertaking. Significant time was spent negotiating that undertaking with the ACCC, including in the context of addressing concerns arising from market inquiries. Digitisation proceeded on the basis of this exemption order at considerable cost. However, the ACCC's decision to grant an exemption was subsequently overturned on appeal, well down the track after digitisation had occurred - exposing the parties to considerable regulatory risk.

The Productivity Commission itself was aware of the regulatory risk surrounding the digitisation at the time it wrote its 2001 Final Report. Ironically, the Productivity Commission used the Telstra and Foxtel digitisation as a key example of the need for greater regulatory certainty in this area, commenting (in Box 9.6),

> "News, as one of three FOXTEL shareholders, is currently considering whether to make an investment in digital subscription television broadcast carriage services, by cable (digital pay TV services). The discussion amongst the FOXTEL shareholders has proceeded on the assumption that the investment will be made in an environment in which access may need to be provided to digital pay TV carriage services. However, the uncertainty which is inherent in the processes makes it difficult, at best, and impossible, at worst, for News to predict the terms and conditions of access and the financial and business consequences thereof. Consequently, the likelihood of further investments decreases (News Ltd sub. DR105, p. 2)"

The problems evident in this case may have significant flow-on effects in relation to levels of confidence in investing in other services and technologies. In the face of such uncertainty, there is a continuing significant regulatory risk in relation to infrastructure investment in Australia. Telstra suggests that further improvements

are needed to the Part XIC access regime to provide greater investor confidence in relation to new and emerging technologies, as identified later in this submission.

As detailed at length later in this submission, the Part XIC access regime, and the access pricing principles that are already embedded within it, may also deter efficient investment. If it continues to enforce access prices for declared services that are below cost, the ACCC reduces the incentives for infrastructure providers to invest in new infrastructure. The ACCC also reduces the incentives for Telstra's competitors to invest in any alternative competitive network.

Deflating access prices promotes short-term increased market entry and competition. However, it creates significant long-term disincentives for investment, so has a long-term adverse impact on the sustainability of that competition.

6 WHETHER THERE ARE ANY STRUCTURAL ISSUES IN THE AUSTRALIAN TELECOMMUNICATIONS SECTOR INHIBITING THE EFFECTIVENESS OF THE CURRENT REGULATORY REGIME

6.1 The Australian regulatory regime already addresses pre-existing structural issues

A key basis for the current regulatory regime is to address structural issues that may otherwise impede efficiency, investment and competition. It is not necessarily structural issues that are inhibiting the effectiveness of the current regulatory regime, rather the key issue is whether the current regulatory regime effectively addresses any structural issues that are materially impeding efficiency, investment and competition.

The current regulatory regime was designed by policy-makers to address structural issues in the Australian telecommunications sector at the time. Many of these concerns have now been addressed and the Australian regulatory regime has evolved with specific regard to pre-existing structural issues. These issues were canvassed, in considerable detail, in the Productivity Commission's 2001 report into *Telecommunications Competition Regulation* so are not outlined in this submission. However, by way of example only:

- Concerns over legacy ownership of last-mile infrastructure have been addressed by such measures as the Part XIC access regime.

- Concerns over vertical integration have been addressed by such measures as the development of a long-term accounting separation and reporting regime.

With a comprehensive and highly competitive access market, Telstra does not believe any structural issues are inhibiting the development of competition in the telecommunications sector that have not already been adequately addressed by the existing regulatory regime.

Yet Telstra notes, as identified in the context of Term of Reference 8 below, that there is a risk that the regulatory regime *itself* is now distorting effective investment in some areas, impeding long-term competition.

6.2 Structural separation of Telstra is not an appropriate policy solution

Some have suggested that physical structural separation of Telstra or divestiture of particular Telstra assets should occur to promote industry competition. However, as the Government has expressly recognised, such structural reforms impose significant real costs that greatly exceed any likely potential resulting benefits.

The Page Research Centre reached the same conclusion in its report to the Australian Government earlier this year. The report concluded (at page 18):

> "The Page Research Centre believes that structural separation would prove administratively difficult and may impact on the overall value of Telstra."

It has become apparent that structural separation in telecommunications imposes large costs in terms of efficiency and international competitiveness. Structural

separation results in a loss of the efficiencies that are achieved through vertical integration. As a result, customers are forced to bear higher costs. In addition, it is not clear that there are significant benefits from separation, especially not of the order required to outweigh the substantial costs involved.

The international experience with structural separation in telecommunications has also been, at best, mixed. By way of example:

- United States: The US has not abandoned structural separation overnight, but the *Telecommunications Act of 1996* (US) is designed to eliminate this constraint on the regional Bell operating companies. Regulatory decisions in a number of States, namely New York, Texas, Kansas and Oklahoma and Massachusetts have allowed the local Bell operating company to supply long distance telephony.

  US regulators have recently revisited the issue of structural separation in other areas. In March 2001, the Pennsylvania Public Utilities Commission (PUC) rejected the structural separation of Verizon's (Bell Atlantic) network and retail operations in Pennsylvania, instead requiring the company to undergo more detailed accounting separation (which it termed 'functional structural separation'). An estimate of the extent of economies of scale and scope can be seen in Verizon's estimate of the restructuring costs associated with structural separation - a one-off cost of US$800 million, with ongoing cost of US$300 million per annum. The PUC commented:

  > "... the parties have convincingly argued that even with the implementation of structural separation of Verizon's wholesale and retail arms, no less regulatory oversight than that currently prevailing will be required to ensure compliance."

- United Kingdom: OFTEL did not support structural separation of British Telecom (BT), believing that appropriate accounting separation and prohibition on cross subsidy can ensure the benefits available through economies of scope are passed on to customers. In 1999, OFTEL stated:

  > "Oftel is not proposing to pursue this option [structural separation] because:
  >
  > Many enhanced services are closely connected to the provision of network services. In practice, it could be difficult to separate the assets used in both activities - and any such separation could involve a high degree of cross selling;
  >
  > Oftel has always considered there to be benefits from the integration of network and enhanced services arising from the sharing of different facilities (economies of scope). These advantages are likely to benefit the customer as long as regulatory controls on abuse of dominance including accounting separation and the prohibitions on unfair cross subsidy and undue discrimination enable fair competition in the market."

  In its *Strategic Review of Telecommunications* Phase 2 Consultation Document,[7] OFCOM proposed that the most effective way to combat structural issues is to address concerns about barriers to wholesale access to BT's network. OFCOM indicated that, rather than requiring structural

[7] http://www.ofcom.org.uk/consult/condocs/telecoms_p2/tsrphase2/maincondoc.pdf

separation, this would involve BT delivering equality of access to its networks as well as implementing behavioural organisational changes to ensure that its competitors are able to obtain access on an equal footing with BT's retail businesses. Even more recently, the United Kingdom Trade and Industry Committee, commenting on the *Strategic Review of Telecommunications*, indicated that it was unconvinced of the need to force BT to structurally separate; and stated that it considered that pursuing equality of access was the best regulatory approach.[8]

BT has since voluntarily offered a form of operational separation, although notably a prerequisite to the offer is the removal of regulation in other areas.

6.3 Accounting separation measures are extensive and already address many key concerns

Benefits similar to those achieved by structural separation can be easily achieved by other less-costly regulatory instruments. These include measures such as accounting separation and reporting.

Australian legislation already has measures in place that go some significant way towards being a substitute for structural separation. In April 2002, for example, the Communications Minister announced that the Commonwealth Government required accounting separation of Telstra's wholesale and retail arrangements in order to ensure Telstra's wholesale business treats all retail providers in an equitable fashion.

On 19 June 2003, the Communications Minister issued an Accounting Separation Direction to the ACCC requiring it to issue record keeping rules giving effect to that direction:

- One requirement of the direction is for Telstra to update its regulatory accounting records from historic to current cost. Regulatory accounts for the core PSTN services of PSTN interconnection, local call resale and unconditioned local loop will provide a basis for comparison in relation to any existing regulated prices for these products.

- An additional requirement under the accounting separation rules is for Telstra to publish imputation test results for various PSTN services including basic access, local calls, national long distance, international long distance and fixed to mobile services. An imputation tests measures whether an efficient competitor of Telstra can compete against Telstra's retail product offering, based on Telstra's retail price and an assessment of the efficient wholesale and retail costs to the competitor of providing the service. In the context of the accounting separation obligations, these costs are determined by the information in Telstra's regulatory accounts.

- A further requirement relating to the accounting separation obligations is for the ACCC to publish a series of metrics that compare Telstra's performance

[8] See http://www.publications.parliament.uk/pa/cm/cmtrdind.htm, 5th April 2005.

in terms of new service connections and fault rectification for both wholesale and retail customers.

The accounting separation requirements are extensive and thorough and significant Telstra resources have been dedicated to the task of updating our regulatory accounts and undertaking the tests specified in the record keeping rules. Telstra agrees with the ACCC that the current cost accounting requirements have raised complex issues of implementation and further work remains to be done to refine the regime. However, this does not mean that all the results published so far should be discredited. To date, the information published under the accounting separation rules has failed to demonstrate any systemic discrimination by Telstra in relation to its service connections and fault rectifications for wholesale and retail customers, a fact regularly confirmed by the ACCC. Nor have the accounting separation reports revealed any margin squeeze by Telstra concerning Telstra's wholesale and retail prices. Rather than being taken to be evidence of Telstra's competitive (or benign) behaviour, the ACCC has regularly downplayed the value of the information published under the accounting separation rules, largely disregarding it in their calls for further evidence of the need for greater regulation and transparency.

The fact that the accounting separation rules do not provide the ACCC or Telstra's competitors with evidence substantiating allegations of anti-competitive behaviour is not due to a failure of accounting separation; rather it is because Telstra has not engaged in such behavior.

In May 2001, the ACCC also introduced accounting separation measures under its regulatory accounting framework ("**RAF**").[9] The RAF requirements constitute both horizontal and vertical accounting separation requirements, providing transparency of Telstra's cost and revenue related information to assist the ACCC with access and market conduct related inquiries.

The RAF provides the ACCC with a detailed analysis of service costs and a clear insight into the cost structures of Telstra at both total wholesale and retail service levels. For each wholesale and retail service, the RAF provides cost information defined by:

- category (for example, CAN, transmission and human resources);
- cost type (that is, operations and maintenance, depreciation and mean capital employed); and
- attribution type (that is, direct, attributable and unattributable).

Apart from providing the ACCC with information relating to all declared services (which the ACCC can use in relation to its arbitration of access disputes under Part XIC), the RAF assists the ACCC in its market conduct regulation by revealing the direct, directly attributable and unattributable costs for retail and declared services.

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[9] The RAF is available at: http://www.accc.gov.au/content/item.phtml?itemId=598800&nodeId=file4240fec77dbd2&fn=Record%20keeping%20rules%20-%20Regulatory%20accounting%20framework%20(May%202001).zip

These cost figures may then be compared with revenues earned to calculate the profitability of any service. The RAF can also be used to assess allegations such as predatory pricing or vertical price squeezing.

The ACCC has itself expressed the view that the RAF will provide it with full transparency of Telstra's cost and revenue information, noting that the regime:

> "... means costs can be clearly allocated to specific services with direct, attributable and unattributable elements separately identified across the retail and wholesale components of a carrier's business. The benefits of this approach are:
>
> - for the Commission, ***it will minimise opportunities for cost manipulation*** and provide a basis for comparing costs across different carriers and carriage service providers and the market;
>
> - it will provide regular and audited financial and other information ..."[10]

As the emphasised words indicate, the RAF constrains Telstra and other carriers from manipulating their costs and therefore provides the ACCC with a fair and reasonable guide as to costs and revenues for relevant services. If, however, the ACCC considers that the information in the RAF is not sufficiently granular for it to resolve access or market conduct issues, then the ACCC can still use that information as a first point of reference for seeking further, more detailed, information to assist it with those inquiries under its record keeping rules powers.

The RAF also applies to the subsidiaries of carriers and carriage service providers if those entities are carriers or carriage service providers themselves, and from whom it is relevant for the ACCC to require reports. Accordingly, the ACCC has directed various Telstra subsidiaries to report under the RAF requirements.

The reporting by Telstra and these subsidiaries provides the ACCC with clear insights into all of Telstra's general cost and revenue information for all relevant line items in Telstra's accounts for declared and other wholesale services, as well as the specific services provided by these subsidiaries.

Consequently, concerns about the absence of structural separation measures are already addressed under the range of regulatory obligations detailed above.

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10 ACCC, *Regulation Impact Statement for the Telecommunications Industry Regulatory Accounting Framework made under section 151BU of the Trade Practices Act 1974*, May 2001, 5 (emphasis added).

7 WHETHER CONSUMER PROTECTION SAFEGUARDS IN THE CURRENT REGIME PROVIDE EFFECTIVE AND COMPREHENSIVE PROTECTION FOR USERS OF SERVICE

7.1 The consumer protection safeguards in the current regime are already extensive

The consumer protection safeguards currently applying to the telecommunications sector on a sector-specific basis are set out within both legislative obligations and self-regulatory industry codes.

The importance of industry codes as a basis for consumer protection was emphasised by the Telecommunications Industry Ombudsman in its Annual Report 2004 in the following terms (at page 11):

> "The Australian Communications Industry Forum's (ACIF) Consumer Codes are one of the most important underpinnings of the co-regulatory consumer protection regime for the telecommunications industry."

The consumer protection safeguards in the current regime are very extensive. The telecommunications sector remains one of the most heavily regulated sectors, from a consumer protection perspective, in Australia.

By way of illustration, the range of safeguards currently applying to the telecommunications sector on a sector-specific basis, for example, includes:

- a range of voluntary and mandatory industry codes and standards, covering such matters as unwelcome calls, call charging and billing, network performance, preselection, commercial churn, calling number display, complaint handling, customer information provision, billing, credit management, customer transfer, local and mobile number portability, emergency call services, priority assistance, and customer fault management;
- obligations relating to privacy and the protection of communications;
- preselection, call override, call barring and calling line identification obligations;
- technical standards, equipment labelling obligations and disability standards; numbering obligations and number portability.
- obligations relating to the use of standard agreements for the supply of services;
- obligations relating to itemised billing;
- obligations relating to access to customer premises;
- universal service obligations and the digital data service obligation;
- quality of service obligations, customer service guarantees and network reliability obligations;
- priority assistance and disability obligations;

- mandatory obligations to the Telecommunications Industry Ombudsman;
- retail price restrictions, local call charge restrictions and other price restrictions and price caps;
- directory assistance services, service charges and white pages directories issues;
- protected payments for residential customers; and
- telephone sex services.

Broadcasting sector-specific regulatory obligations may also apply, particularly in relation to content services and Internet services, including issues relating to email spamming and Internet dumping. To the extent some telecommunications services may involve novel payment mechanisms, financial sector consumer protection obligations may apply.

In addition to this sector-specific legislation, there is also the full range of generic consumer-protection legislation at both the Commonwealth and State levels including, for example, Part V of the Trade Practices Act 1974 and the Privacy Act. There are also a range of mandatory generic consumer protection codes and compliance requirements.

Telstra submits that the current level of regulation is frequently inconsistent in application. There is a significant degree of overlap of existing regulation, imposing unnecessary costs. Telstra believes that existing regulation should be rationalised with a view to ensuring consistency, symmetry and certainty.

8 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

8.1 Telstra refers to its February 2005 submission on these issues

Telstra provided a detailed submission in relation to the Senate Committee's earlier inquiry titled *The Powers of Australia's Communications Regulators*. The Terms of Reference addressed by that submission are almost identical to this Term of Reference.

To avoid duplication, Telstra refers to its previous submission to the Senate Committee dated 4 February 2005. However, Telstra has summarised some parts of that submission below for convenience.

8.2 The existing powers of the ACMA (to be formed) and ACCC are already sufficient

In Telstra's view, the existing powers of the ACMA and ACCC are already more than sufficient. An examination of the powers of ACMA and the ACCC reveals an extensive regulatory reach, touching on all facets of the telecommunications industry, including competition, consumer, technical and social policy.

- Telstra submits that the ACMA already has ample powers to deal with technical, content and sectoral issues. There is no need to increase the powers of the ACMA relative to the ACA and ABA.

- The ACCC has ample powers to deal with market issues that have a competition dimension.

8.3 The powers of the ACCC are greater than other generic competition regulators

In the specific context of telecommunications, the ACCC already has substantial regulatory powers spread over the *Trade Practices Act 1974*, the *Telecommunications Act 1997* and the *Telecommunications (Consumer Protection and Service Standards) Act 1999*. Telstra set out an extensive list of the current functions and powers of the ACCC in its submission of February 2005.

For the purposes of its February 2005 submission, Telstra compared the powers of the FCC and OFCOM with those of the ACCC. Telstra's general conclusion from this comparison was that while the powers of the ACCC are generally consistent with those in other jurisdictions, the regulatory powers in other jurisdictions tend to be more widely dispersed and less concentrated in the hands of a single regulator.

In many other jurisdictions (e.g., United States, Canada, Germany, Italy) the equivalent of the ACMA, as sectoral regulator, is responsible for sectoral access regulation; rather than the generic competition regulator. This is the converse of Australia where considerable sectoral regulatory powers have been given to the generic competition regulator, the ACCC.

Regulatory environments rarely develop in tandem but evolve in different timeframes in different constitutional, political, and socio-economic contexts. Even

so, there are strong similarities between Australia and the United Kingdom, the United States and many European countries which validate any comparison:

- United States: The US exhibits a very high degree of separation of regulatory power in the telecommunications sector. There is no single agency or institution in charge of telecommunications competition policy. Rather, regulation is derived from an interplay of multiple agencies and industry actors, at multiple levels of jurisdiction, both horizontally (within the federal government) and vertically (between state, local and federal governments).

  The FCC is a congressionally authorised independent agency and enforces technical, economic and access regulation. The Justice Department, through its Antitrust Division, enforces the generic competition laws in cases involving telecommunications carriers. The FTC, an independent Federal agency, is also charged with preventing unfair and deceptive market practices by companies operating in the United States, but is prevented by statute from reviewing mergers of telecommunications common carriers.

  Pursuant to their jurisdiction over intrastate services, the various states of the United States also maintain boards, commissions or departments within their governments to regulate the *intra*-state activities of telecommunications utilities. This division of labour may strike Australian eyes as chaotic, but in practice the checks and balances in the system ensures that regulation is tightly targeted at points of market failure and that the intervention itself is carefully crafted to ensure as efficient outcomes as possible.

- Canada: The Canadian Radio-television and Telecommunications Commission (CRTC) is an independent agency regulating telecommunications and broadcasting, but does not regulate competition issues. The Canadian Competition Bureau is responsible for the administration of generic competition law. The CRTC rather than the CCB regulates telecommunications access issues.

- United Kingdom: OFCOM has regulatory responsibilities across television, radio, telecommunications and wireless communications services. The Office of Fair Trading applies and enforces the generic competition provisions of the Competition Act. Interestingly, both regulators have concurrent jurisdiction in relation to anti-competitive behaviour and hence must co-ordinate enforcement activities.

- Germany and Italy: Telstra understands that the competition authorities of Germany and Italy are the principal authorities responsible for the enforcement of competition law. In both jurisdictions, sectoral regulation (including access regulation) is enforced by the sectoral regulator. However, there is significant consultation between the respective entities.

Based on this analysis, Telstra believes that the powers of the ACCC in Australia are generally greater than the powers of generic competition regulators in other comparable jurisdictions. In effect, Australia's generic competition regulator has a significant additional role as a sectoral regulator, creating an unusually high

concentration of regulatory power in the hands of the generic competition regulator.

The Productivity Commission in its 2001 Final Report commented (at page 306), for example: "*Australia's incorporation of telecommunications oversight into a general competition regulator, the ACCC, is rather unusual by world standards.*"

9 THE IMPACT THAT THE POTENTIAL PRIVATISATION OF TELSTRA WOULD HAVE ON THE EFFECTIVENESS OF THE CURRENT REGULATORY REGIME

9.1 The ownership of Telstra is not causally related to the effectiveness of the regime

Telstra believes that the issue of its current and future ownership should have no bearing whatsoever on the effectiveness of the current regulatory regime. The current regulatory regime does not depend on Government ownership of Telstra for its effectiveness. There is no causal relationship between these issues and any suggestion to the contrary evidences a misunderstanding of the Australian regulatory regime.

This Term of Reference appears to assume that Telstra's compliance with the regulatory regime, and hence its effectiveness, is dependent on continued Government ownership. Telstra notes that this assumption is not correct for reasons including the following:

- Telstra is a publicly listed company with a board of directors. These directors have duties to the company as a whole, not just the Government as a 51.8% shareholder. The remaining shareholding is widely held by around 1.6 million shareholders.

- Australian Government involvement in Telstra's business activities is governed by the *Telstra Corporation Act 1991 (Cth)*.

As one of Australia's largest companies with a high degree of brand recognition and goodwill, Telstra takes its legal compliance obligations extremely seriously. Telstra prides itself on being a good corporate citizen. Telstra would comply with its legal obligations irrespective whether it was Government owned or not.

- There are no conditions in the Australian regulatory regime that impose obligations on Telstra simply because it is majority Government owned. While Telstra has certain additional obligations, such as universal service provider, these are not dependent on Government ownership and would no doubt persist into privatisation.

- The Government and Parliament will continue to retain the ability to regulate the telecommunications landscape. The Government and Parliament do not lose this ability because Telstra is fully privatised.

10 WHETHER THE 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

10.1 USO already ensures that all Australians have access to standard telephone services

A key policy concern of the Australian government is that consumers in remote rural areas are given the same standard of telecommunications services, at relatively the same cost, as consumers in the major Australian capital cities. In particular, the government's express policy is that standard telephone services should be reasonably available to all people in Australia on an equitable basis, regardless of where they reside or carry on business.

Part 2 of the *Telecommunications (Consumer Protection and Service Standards) Act 1999* ("TCPSS Act") sets out the requirements for universal service. Universal service providers must ensure that the standard telephone service (STS), payphones and any prescribed carriage services are reasonably accessible to Australians on an equitable basis, regardless of where they reside or carry on business. Under the conditions of its carrier licence, Telstra is currently the Australian "universal service provider". Telstra is the only provider required to supply the STS.

The USO ensures that all people in Australia, wherever they reside or carry on business, have reasonable access to the STS. The TCPSS Act defines the STS as a carriage service providing voice telephony, or an equivalent service that meets the requirements of that Act and the *Disability Discrimination Act 1992*. The STS also includes provision of an appropriate handset, or other customer equipment, that enables a person with a disability to communicate over a telephony network.

As the universal service provider, Telstra has in place a standard marketing plan (SMP) and USO policy statement that set out its arrangements for providing services under the USO. A failure by Telstra to comply with provisions under the SMP would constitute a contravention of its carrier licence conditions. Under its SMP, Telstra is required to offer USO customers access to an interim or alternative service when there is an extended delay in connecting or repairing the STS.

The USO arrangements also include an obligation to provide a digital data service—the DDSO. The purpose of the DDSO is to ensure that all Australians have access to data services with download rates of at least 64 kilobits per second (kbit/s) on request.

Against this backdrop, it is important to recognise that:

- Telstra pays the lion's share of the USO - around 70% of the (deemed) cost contributing $160 million in 2003-04, with the next largest contributor carrier paying only 18% or $41 million (Optus).

- Telstra is the only carrier mandated to connect uneconomic customers to the network as the carrier of last resort. This means that Telstra is the only company obliged to service these customers when other carriers are not doing so;

- In trial programs designed to make provision of USO services contestable, no other carriers expressed an interest in providing services in competition to Telstra, although subsidies similar to those available to Telstra were made available;

- While the company contests what it considers to be the true cost of providing the USO, Telstra – unlike some other industry participants - accepts that the USO is a fundamental cost of doing business in the Australian telecommunications industry and an important social obligation; and

Telstra's competitors are able to take advantage of USO-funded infrastructure by reselling Telstra's services which they purchase at rates regulated by the ACCC. Competition on this basis is significant and would not be possible without the USO.

10.2 Funding of the USO remains an ongoing concern

The underlying costs of providing basic telephony services to rural areas are significantly greater than providing such basic telephony services to metropolitan areas. Accordingly, Telstra provides telephony services to some areas of rural and remote Australia at a loss. To assist Telstra to recover some of this loss, the Australian government imposes a universal service levy on all carriers, including Telstra, and then redistributes that levy to Telstra.

In particular, universal service providers and digital data service providers are able to submit claims for universal service subsidies and digital data costs incurred throughout the financial year. These costs are shared among participating persons (carriers) from the year before the claims are submitted. The amount contributed by each participating person is based on its share of total eligible revenue. All carriers therefore contribute to the cost of providing the USO, NRS and DDSO.

The level of that levy has proved controversial. Other participants in the telecommunications industry appear reluctant to bear the cost of what they consider is essentially an Australian Government social policy. The Productivity Commission commented in its 2001 Final Report (at page 565):

> "Methodologies have been contentious and have been changed several times since 1991. In particular, there have been disputes about the calculation of Telstra's net loss in the provision of universal services. These disputes have been far from trivial. For example, in respect of 1997-98, the first year in which the net universal service cost (NUSC) model was applied (see below):
>
> - Telstra initially claimed a NUSC of over $1.8 billion;
>
> - the Minister introduced legislation to cap it at $253.32 million;
>
> - the ACA subsequently assessed it at over $548 million; but
>
> - the legislative cap prevailed."

For 2004-05, the Minister determined the USO levy at AU$211.3 million. Telstra maintains that this figure under-estimates the true cost of funding the USO, imposing an additional burden on Telstra to make up the funding shortfall. This is clearly of concern for the reasons identified by the Productivity Commission in its 2001 Final Report (at pages 570 and 578):

> "...given that Telstra is required by regulation to supply loss making services that it might not choose to supply given the choice, it is also important to ensure that the levy meets its legitimate (additional) costs. Apart from any equity considerations, underestimation of avoidable costs could affect investment decisions...
>
> ...it is important that the universal service levy be struck at an amount that at least approximates, in aggregate, the actual net costs of universal service provision. Otherwise, as illustrated above, both competitive neutrality and efficiency can be adversely affected..."

From 1991, the Government introduced a USO tendering policy known as "USO contestability". Telstra notes that no operators registered to be a participant in the tender, indicating that Telstra's claims regarding USO costs may be reflective of the actual costs involved in supplying the USO.

Telstra understands that the costing of the USO remains highly controversial. In its report earlier this year, the Page Research Centre made the following comments and recommendation, for example (at page 14):

> "The Page Research Centre has heard a number of conflicting views on the cost of the USO. Telecommunications providers tend to agree that there is a need for the USO but dispute the cost and contribution telecommunications companies must make. One side of the argument is that there are financial benefits to providing the USO. A government commissioned study and a study funded by Optus found the USO provider receives a benefit of between $70 and $136 million.[11] However, the current USO provider, Telstra, argues that managing the USO cost approximately $550 million[12]. Meanwhile the government has estimated the cost at $211 million.

The Page Research Centre also recommended that an independent audit be conducted to ascertain the exact cost of the USO.

10.3 Telstra is also subject to a range of other obligations to provide high quality of service

Telstra is also subject to an extensive range of other social policy obligations, extending beyond the USO, to ensure all Australians receive an adequate quality of telecommunications services. The key obligations are as follows:

- Customer Service Guarantees (CSGs): At the direction of the Communications Minister, the ACA has made mandatory standards for CSPs (including Telstra) in relation to the provision and repair of standard telephone services and the keeping of customer appointments associated with these activities. These customer service standards have been in effect since 1 January 1998. A revised CSG Standard came into effect in July 2000

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11 See Singtel Optus, *Policy directions in telecommunications: rural and regional funding*, submission to the advisory group, p. 5

12 See Telstra, *Regulatory Overview and Implications for Regional Service Equity*, submission to the advisory group, p. 10.

which clarifies that the new standard only applies to eligible customers with five or less standard telephone services, but also tightens some connection and restoration timeframes. Damages are payable by Telstra to customers if Telstra fails to meet the CSG Standard, capped at $25,000 per customer for each contravention.

- Network Reliability Framework (NRF): The NRF is an outcome of the Telecommunications Services Inquiry (Besley Inquiry) which was conducted during 2000. The NRF was introduced through an amendment to Telstra's carrier licence conditions, which took effect from 1 January 2003, and embraces CSG telephone services only (as identified above). The NRF is a compliance and reporting framework that aims to improve the reliability of Telstra's network at three different levels:

    - Level 1 - Telstra is required to provide a monthly report to the ACA on the percentage of CSG services with no faults and the average percentage of service availability for each of 44 geographical areas throughout Australia.

    - Level 2 - Telstra is required to provide monthly reports to the ACA for those exchange service areas (5000 throughout Australia) where a pre-determined number of CSG services have had one or more faults in each of the two preceding calendar months. The ACA can request further information from Telstra regarding the performance of a particular ESA and may seek to have remedial action undertaken to reduce the incidence of faults in a particular ESA.

    - Level 3 - Telstra is required to take reasonable action to prevent a CSG service from experiencing four or more faults in a rolling 60 day period or experiencing five or more faults in a year. Where either of these thresholds are breached, Telstra is required to investigate the reason for the breach, undertake such remediation as is necessary and report the contravention to the ACA.

- Priority Assistance: The Communications Minister made an amendment to Telstra's carrier licence conditions in May 2002 requiring Telstra to implement arrangements for maximising service continuity to priority customers. As part of these arrangements, Telstra has developed and implemented, and must maintain, a documented priority assistance policy. Telstra must also have processes, systems and practices in place to ensure that priority customers can be identified and provided with priority assistance in accordance with Telstra's priority assistance for individuals policy. The Communications Minister approved Telstra's policy on 17 June 2002. As at 30 June 2004, Telstra had over 100,000 customers with priority assistance status.

Telstra believes that the USO, in conjunction with the other key obligations identified above, already ensure that all Australians have access to reasonable telecommunications services.

10.4 If the scope of the USO is increased, the increased USO should be fully funded

If the USO was revisitedto increase the scope of services covered, the additional costs of rolling out such services in rural and remote areas of Australia may be very substantial, potentially in the billions of dollars.

The USO is essentially a means by which Australian consumers living in lower-cost CBD and metropolitan areas cross-subsidise the higher costs of providing telephony services to Australian consumers living in high-cost rural and remote areas of Australia. The cost of supplying telecommunications services to some of the more remote areas of Australia can be extraordinarily high. Indeed, in some instances it is simply not economic to roll-out a fixed line network (hence consumers are provided with services such as satellite phones). The majority of the costs of meeting these requirements are ultimately borne by Telstra's shareholders.

Telstra submits that careful policy consideration is required if any decision is to be made by the Government to increase the scope of the USO. The benefits to rural and regional consumers will need to be balanced against the costs to the remainder of Australia. Ultimately, the appropriate level of the USO is a political matter for determination by Government.

Furthermore, much of the cost of an extended USO would never be recovered. As default USO provider, it is probable that Telstra would be expected to supply the services required by the USO, so would bear the associated costs. Given that the USO is a Government social policy, any non-recoverable rollout costs should be appropriately funded from general taxation revenue or via consumer or industry levies in relation to USO funding, consistent with the practice of almost every other industry subject to community service obligations.

It is also notable that international requirements in relation to the USO form part of Australia's international obligations, as set out in the *WTO Regulatory Reference Paper* which forms part of the *WTO Agreement on Basic Telecommunications*. The Reference Paper contains the following obligation, emphasising the principle that the cost burden of a USO is to be spread on a non-discriminatory basis between industry participants so that one participant (i.e., Telstra) does not bear a disproportionate burden of the costs:

> "Universal Service: Any Member has the right to define the kind of universal service obligation it wishes to maintain. Such obligations will not be regarded as anti-competitive provided they are administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined by the Member." [13]

[13] http://www.itu.int/newsarchive/press/WTPF98/WTORefpaper.html#UniversalService

11 WHETHER THE CURRENT REGULATORY ENVIRONMENT PROVIDES PARTICIPANTS WITH ADEQUATE CERTAINTY TO PROMOTE INVESTMENT, MOST PARTICULARLY IN INFRASTRUCTURE SUCH AS OPTICAL FIBRE NETWORKS

11.1 Importance of greater investment certainty

In Telstra's view, investment in efficient new telecommunications infrastructure is the most important factor in ensuring that Australia continues to reap the benefits of the digital age. As the ACA has recognised, attracting sufficient funds for such investment is a key challenge now facing the Australian telecommunications industry. The ACA commented in the ACA 2004 Report (at page 21) in relation to the deployment of new telecommunications technologies:

> "The greatest barrier to deployment of these services is likely to be the cost and scarcity of investment funding for such projects, particularly wireline and optical fibre cable infrastructure requiring significant capital works, and scarce radiofrequency spectrum resources."

From Telstra's perspective, such investment is important for at least two principal reasons:

- major demands are being, and will continue to be, placed upon Telstra to undertake a complete upgrade of its existing copper network in order to meet the increasing service quality standards imposed by consumer expectations and regulation; and

- technological changes have meant that the network of the future is constantly evolving and changing. New technologies and new infrastructure will be needed.

As noted, Telstra is concerned that aspects of the access regime are generating uncertainty and may be stifling investment. Telstra's detailed comments in relation to those issues are, however, set out above in Section 5 and are not repeated here.

12 WHETHER THE CURRENT REGIME PROMOTES THE EMERGENCE OF INNOVATIVE TECHNOLOGIES

12.1 The regime has a degree of technological neutrality, but refinements are required

In most jurisdictions, sectoral regulation is significantly different in its treatment of different media. Such regulatory differences create a number of potential regulatory costs and risks:

- unnecessary regulatory restrictions on the use of infrastructure;
- regulatory uncertainty, usually arising from the application of regulation intended for one technology to new technologies (e.g., voice over IP);
- inconsistent requirements for market entry and licensing;
- inconsistent approaches to the achievement of the same public interest objectives;
- inconsistent standards for similar concepts between different industries; and
- inappropriate regulation, particularly in relation to access to last mile infrastructure and radiocommunications spectrum.

In light of these costs and risks, a number of jurisdictions have sought to better harmonise their regulatory framework across convergent media.

These jurisdictions have adopted an important *principle of technological neutrality* with a view to preventing market distortions and reducing regulatory barriers. Technological neutrality is intended to increase regulatory flexibility. In its review of Australian *Telecommunications Competition Regulation* in 2001, the Productivity Commission commented as follows:

> "Policy should be technologically neutral. While not limited to the telecommunications industry, rapid and unpredictable technological shifts in telecommunications highlight the importance of avoiding a regulatory bias towards particular technologies or design standards. Past distinctions between different telecommunications markets are blurring, and the evidence suggests this will continue. The benefits of remaining technologically neutral in regulation are clear at the best of times, but it is a particularly important principle in times of rapid technological change. Problems can arise very quickly where governments are seen to mandate such matters."

Consistent with international best practice and the Productivity Commission's recommendations, Telstra believes that the current Australian regulatory regime already has a high degree of technological neutrality. This is generally commendable and will promote the emergence of innovative technologies while ensuring that regulation, properly applied, is readily adaptable to changing technologies.

However, some key refinements to the current regulatory regime may be required in light of some of the more innovative recent technologies. Many of these new technologies were never envisaged by the drafters of the Australian telecommunications regime back in 1996, around a decade ago, so sit uneasily

with many of the historic regulatory constructs. Telstra has made some comments below in relation to IP-based services (particularly Voice over IP or "VoIP") by way of example only.

The ACA has also made the following comments in the ACA 2004 Report (at pages 22 and 26), in relation to the migration to IP-based services, further illustrating the importance of this issue:

> "As telecommunications services converge and consumers increase the function and circumstances of their use of these services, regulation needs to be flexible enough to respond to emerging issues, while avoiding unnecessary intervention where new services offer significant potential benefits.
>
> Developments in the transition to broadband connectivity are likely to force a mind-shift in the regulation of communications. Legacy arrangements may need to run in parallel with new approaches designed for Internet-based applications and services. Regulatory process redesign over the next few years is likely to be as much of a challenge as keeping up with innovation, convergence, internationalisation and social and cultural change."

The ACA and the industry are recognising that legacy regulation in the Australian telecommunications market will need to be revisited and refined to ensure that regulation keeps pace with innovation, convergence, internationalisation and social and cultural change.

12.2 Voice over IP as an example

IP telephony services (of which Voice over IP is just one application) are services that will evolve both technically and competitively over the next one to five years. IP telephony provides a useful example of the difficulties currently being encountered by Australian regulators and the industry in applying legacy regulation to the more innovative technologies of the 21st century.

As Telstra has recently indicated in submissions to the ACA, a number of critical definitions in the Australian telecommunications regulatory framework, such as the concept of a "standard telephone service", were developed in the context of a dedicated hierarchical PSTN. These definitions apply somewhat uneasily to new technologies such as Voice over IP, raising issues as to which regulatory obligations should apply in the long term.

In particular, in its current form, the definition of a Standard Telephone Service (STS) in the TCPSS Act is broad and appears to apply to most IP telephony services and across all customer segments of the Australian market. Whether the current regulatory obligations need apply to IP telephony services, and if so, to the whole market or to a narrower segment of consumers, are important matters that will require further consideration by policy makers. An important issue to consider in that regard will be how to feasibly distinguish between different customer segments.

Regulatory touchstones such as access to emergency services will remain important for consumers (to remove the scope for confusion) no matter what the underlying technology that is used for making telephone calls. As a result, there may be a need for continuation of such regulatory obligations in the short term for new technologies such as VoIP.

For example, customers are accustomed to voice telephony services that provide particular, fundamental, capabilities such as emergency service access (E000 and 106). In this regard, Telstra considers a key issue for the industry will be "how will customers know what features they will receive with their voice services in relation to IP telephony?"

Telstra suggests that there is a need for a careful review by policy-makers of the current regulatory framework in light of new technologies, such as VoIP, to ensure a consistent approach and to avoid impeding the adoption of new technologies. If such an approach is adopted, the current regulatory regime is less likely to impede the adoption of new technologies.

In summary, while it may, in some circumstances, be important to continue regulation for new technologies in the short term (say, to ensure consumers continue to have access to the fundamentally important functionality of E000 for their IP telephony services), it is also important to ensure that regulation only apply to areas of market failure.

Indeed, as a general rule, Telstra would caution against making *a priori* assumptions about the carry-over of existing regulation to new and evolving services. Put differently, the flexibility of the regulatory framework to accommodate new technologies in a technologically neutral fashion should not be a license to regulate. Rather, as technological change occurs, regulation should be reviewed to ensure that it applies only to areas of market failure.

13 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

13.1 International obligations provide guidance as to the appropriate level of regulation

Telstra submits that Australia should look to international obligations for guidance as to the appropriate scale and scope of regulation in the Australian telecommunications sector. Such practices may be viewed as crystallising the informed international consensus regarding the optimal extent of sectoral regulation in the telecommunications industry as refined in light of different country experiences.

International obligations can be identified from a range of sources, including, for example:

- binding multilateral agreements setting out obligations and principles relating to telecommunications regulation, namely the World Trade Organisation (WTO) Agreement on Basic Telecommunications ("WTO Basic Telecoms Agreement");

- principles and policy papers promulgated by key international organisations, such as the World Bank, the International Telecommunications Union (a specialised agency of the United Nations), and the OECD;

- principles and policy papers promulgated by reputable regional entities and organisations, including APEC TEL; and

- binding bilateral agreements setting out principles relating to telecommunications regulation, including within the Singapore-Australia Free Trade Agreement (SAFTA) and the Australia-US Free Trade Agreement (AUSFTA).

The Australian Government has international obligations as a signatory to the WTO Basic Telecoms Agreement. The Australian Government also has obligations under SAFTA and AUSFTA which act as an additional bilateral increment to the Australian Government's obligations under the WTO Basic Telecoms Agreement.

The WTO Basic Telecoms Agreement, in particular, remains the only multilateral agreement currently setting out binding obligations relating to telecommunications regulation and may be viewed as articulating the current international consensus on telecoms regulatory issues.

The WTO Basic Telecoms Agreement comprises a set of schedules under the General Agreement on Trade in Services ("GATS"). In addition to general obligations under the GATS, each nation is bound by its own individual schedule which describes the manner and extent to which that nation must ensure national treatment and market access with respect to specific modes of supply for particular basic telecommunications services. Most of the signatories to the WTO Basic Telecoms Agreement included in their individual schedules a commitment to some or all features of a negotiated "Regulatory Reference Paper," which set out

regulatory principles for the establishment and maintenance of competitive telecommunications markets.

The Reference Paper articulated the following two key obligations relating to domestic telecommunications regulation:

- Competitive safeguards: Appropriate measures must be maintained for the purpose of preventing suppliers who, alone or together, are a major supplier from engaging in or continuing anti-competitive practices.

- Interconnection: Interconnection with a major supplier must be ensured on reasonable, non-discriminatory, terms and conditions and rates for interconnection. A service supplier requesting interconnection with a major supplier must be permitted recourse to an independent domestic body to resolve disputes regarding appropriate terms, conditions and rates for interconnection.

These two key obligations clearly recognise the co-existence of generic competition law (i.e., the "competitive safeguards" obligation) with sectoral regulation (i.e., the "interconnection" obligation). The interconnection obligation also establishes a minimum requirement for sectoral regulation in the telecommunications industry, namely the need for targeted sectoral regulation to ensure interconnection on reasonable terms.

The Reference Paper also recognises the existence of other forms of sectoral regulation in the telecommunications industry, although such other sectoral regulation is not specifically mandated by the Reference Paper.[14] Rather, the Reference Paper prescribes key regulatory principles under which such regulation should be administrated, as follows:

- Universal service: Any nation has the right to define the kind of universal service obligation it wishes to maintain. Such obligations will not be regarded as anti-competitive *per se*, provided they are administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined.

- Licensing criteria: Where a licence is required, the licensing criteria and terms and conditions of individual licences must be made publicly available. If a licence is denied, the reasons must be made available to the applicant.

- Independent regulators: Regulatory agencies must be separate from, and not accountable to, any supplier of basic telecommunications services. The decisions of and the procedures used by regulators must be impartial with respect to all market participants.

- Scarce resources: Any procedures for the allocation and use of scarce resources, including frequencies, numbers and rights of way, must be

[14] See LB Sherman "Introductory Note on Reference Paper to the Telecommunications Annex to GATS" (1997) 36 *ILM* 354.

carried out in an objective, timely, transparent and non-discriminatory manner. The current state of allocated frequency bands must be made publicly available.

Of the other documents articulating international best practice, the World Bank's *Telecommunications Regulation Handbook (2000)* is particularly significant. The World Bank relevantly comments in relation to key regulatory principles (at paragraph 1.1.1):

> "The trend today is towards deregulation. Some traditional forms of telecommunications regulation are now viewed as having been more damaging than beneficial to the development of national telecommunications infrastructure and services. Today, when regulatory measures are proposed or reviewed, governments and regulators must generally ensure that (1) there is a demonstrated need to regulate, and (2) the most efficient measure is selected to meet the specific regulatory objective"

The World Bank also comments (at paragraph 1.4.1):

> "Over the years, more and more regulators have realised that decisive regulatory intervention is required to implement interconnection arrangements that will substantially increase competition. Such intervention includes proactive regulation, that is advanced guidelines, as well as dispute resolution. Regulatory thinking is evolving on this subject.
>
> Regulation of interconnection represents one of the small number of exceptions to the general rule. In most cases, regulation can and should be minimised. Interventionist measures should be assessed against their objectives. Are the objectives valid? If so, are the measures the least intrusive means of achieving the objectives?".

These comments recognise that the sectoral regulation may be necessary in certain circumstances. However, such sectoral regulation should be proportionate to the level of competition and should always be minimised, consistent with a deregulatory approach.

In this manner, international obligations support a level of regulation closely tailored to the level of competition and directed at instances of manifest market failure. As competition develops, regulation should be reduced commensurately.

13.2 The current regulatory regime should adopt a more light-handed regulatory approach

The current scale and scope of regulation present in Australia is excessive relative to the level of competition in telecommunications markets. In Telstra's view, Australia has not yet properly adjusted its regulation to reflect the development of competition.

As indicated earlier in this submission, regulation should only be applied where there is clear evidence of market failure. As the level of competition increases, so the need for regulation will decrease as increased competition will reduce any scope for market failures associated with excessive market power. This result is fundamental to modern competition policy.

Moreover, where regulation does occur, regulatory regimes should seek to minimise the scope for regulatory error. As the Productivity Commission has found, incorrect regulation is often more damaging than no regulation at all.

Telstra submits that Australia is in a situation where significant market entry has occurred. However, Australia's telecommunications regulatory regime has not yet been properly adjusted to reflect this: instead of decreasing the level of regulation, Australia has often increased it.

In particular, Telstra now faces strong, well established competitors – in many instances, the subsidiaries of entities far larger than Telstra itself. Additionally the evidence shows that where competition has not developed to the same extent – primarily in access and local call service – the main impediment is not inherited market power, but rather persistent regulatory intervention that makes it cheaper and easier for competitors to rely on Telstra's network than to build networks of their own. Given this evidence, whatever the case for industry-specific regulation may have been in the past, such regulation now risks slowing the continued development of Australia's telecommunications industry.

14 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

14.1 The performance of the regime is hindered by the continued existence of Part XIB

In Telstra's view, the performance of Australia's regulatory regime is hindered by the continued existence of Part XIB, rather than improved by it. In its 2001 review, the Productivity Commission identified a number of concerns with Part XIB, as identified earlier in this submission. Many of these concerns remain.

Furthermore, Part XIB was only ever intended as a short-term transitional regulatory measure. Once competition had developed, the legislative intent was that Part XIB would be repealed.

Telstra notes, with some concern, that it is a persistent feature of the Australian regulatory landscape that regulators are not willing to forego powers they have obtained and usually seek to have their powers enhanced rather than removed. The history of Part XIB is consistent with that pattern. In this context, it is not surprising that the ACCC has sought even greater powers under the telecommunications-specific provisions of Parts XIB and XIC.

The need for industry-specific, rather than generic, competition rules has long been questioned. The forerunner to the ACCC, the Trade Practices Commission, in making a 1994 submission to the then Federal Government's *Review of Post-1997 Telecommunications Policy*, explicitly rejected the need for industry-specific regulation for telecommunications. One reason the regime was rejected was that it would be difficult for the regulator to relax its controls over market outcomes. The Trade Practices Commission's submission stated (at page 6):

> "[Industry-specific regulation] can distort the allocation of resources by creating unjustifiable disparities between industries;... it may be difficult for these regulators to remove or relax unnecessary regulation if this reduces their ability to guide or control market outcomes; the industry-specific nature of the regime may reduce predictability by preventing or limiting the application of precedents derived from other industries ...".

Furthermore, the Chairman of the Trade Practices Commission at the time, Professor Allan Fels, in a signed foreword to the same document, observed that:

> "The TPC's basic premise in this submission is that general competition law should be applied to the telecommunications industry as far as possible".

Bearing in mind these salutary remarks, the justification for the creation of a telecommunications-specific competition rules under Part XIB, in addition to the generic competition rules under Part IV, was always and continues to be highly questionable.

Telstra's concerns with the continued existence of Part XIB are well-documented and were the subject of extensive submissions to the Productivity Commission in 2000 and 2001. The Productivity Commission accepted many of Telstra's concerns. Telstra's key concerns are briefly summarised below:

- Greater powers have not improved market outcomes: Notwithstanding the ever-widening scope of the ACCC's powers under Part XIB (contrary to the legislative intent that Part XIB would remain a short-term transitional measure), the outcomes resulting from the ACCC's use of, and failure to use, Part XIB remain inconsistent with efficient policy objectives. Rather, the outcomes generated by the ACCC appear to be arbitrary, sometimes at odds with longer term goals of economic efficiency and sustainable competitive growth.

- Part IV is already sufficient: The general competition rules in Part IV of the *Trade Practices Act* have been specifically designed to prevent anti-competitive behaviour by entities with substantial market power. Part IV has provided adequate protection for small firms confronted by very large firms in other industries. In addition, Telstra's competitors are not small by the standards of Australian firms and many have substantial global financial backing. Indeed, all of Telstra's major competitors are substantially owned by global telecommunications carriers, including some multinationals that are substantially larger than Telstra, such as Vodafone.

- Part IV now has substantially increased penalties: The penalties for a contravention of Part IV of the Trade Practices Act are currently being substantially increased. Future penalties will include penalties based on turnover, acting as a very significant deterrent. Such penalties have the potential to greatly exceed any penalties imposed under Part IV. The justification for Part XIB, that it increases the penalties to which Telstra is exposed, no longer exists.

- Part IV would have achieved the same competitive outcomes: All of the conduct pursued by the ACCC under Part XIB could have been pursued as effectively and just as quickly under Part IV, whilst providing greater certainty to industry participants, reducing the risks of costly regulatory error and maintaining appropriate limits on regulatory discretion. The ACCC has substantial and sufficient powers to regulate anti-competitive conduct in all industries, including telecommunications, under Part IV of the *Trade Practices Act* including the ability to act quickly via injunctions.

- Regulatory discretion creates considerable scope for regulatory error: The intention of Part XIB was to reduce administrative time and costs in the challenge of suspected anti-competitive conduct. In practice, Part XIB has greatly increased the scope for regulatory error (that is, mistaking competitive conduct for conduct that harms the competitive process) without alleviating – and perhaps increasing - administrative delay. Part XIB provides significant discretionary power to the ACCC. The lack of accountability of the ACCC for its decisions has increased both the likelihood of errors being made by the ACCC and the severity of the consequences of those errors. Robust competition and arbitrary regulatory authority are fundamentally at odds with each other.

- Part XIC reduces the need for Part XIB: Extensive access obligations are contained in Part XIC of the *Trade Practices Act* in relation to those markets

considered uncompetitive. These obligations facilitate contestability and remove an incumbent's exclusive control over bottleneck facilities.

- **Part XIB has been used as a bargaining tool for costly undertakings:** Part XIB creates an ambiguous regulatory regime that can result in arbitrary and costly enforcement undertakings. Although no case has actually been determined under these provisions, Part XIB has been progressively strengthened. Meanwhile, the ACCC appears to have relied on Part XIB not as a means of law enforcement, but more as a bargaining tool - a means of securing outcomes that it could not obtain through more transparent and accountable legal processes. The threat of proceedings has been used by the ACCC without needing to meet the constraints and hurdles that would be involved in genuine legal and administrative decision-making.

14.2 The balance adopted in the administration of Part XIC should be reconsidered

In Telstra's view, the administration of Part XIC by the ACCC has focussed too much on promoting short-term competitive entry via lower access prices, without adequately addressing the long-term adverse impact of such access pricing on the incentives for long-term infrastructure investment. Telstra suggests that a reconsideration of the balance adopted by the ACCC in the application of Part XIC may be appropriate given that most markets are subject to significant and sustainable competition.

In Telstra's view, such a distorting effect is partly inherent in the costing methodology adopted by the ACCC, and most notably its emphasis on optimisation within a Total Service Long Run Incremental Cost ("TSLRIC") framework. Properly applied, TSLRIC can allow for recovery of costs. However, if inaccurately applied, TSLRIC pricing may become a damaging regulatory tool. If the access regime is designed to maximise the long-term interests of end users, then competitors must be provided with a price signal that will encourage efficient investment both by entrants and the incumbent. The cost of access to the incumbent network should not be priced too low – in particular, it must not be priced below the costs of at least maintaining the network.

An artificially low access price has two damaging effects on investment:

- A low access price discourages efficient investment by infrastructure owners as they will not be able to attract sufficient investment funds to finance a network roll-out relative to competing investment opportunities. They may also decide that the risk-adjusted return exceeds any benefits, or that their money is better allocated to other, more profitable, investment opportunities.

- A low access price discourages efficient investment by market entrants - as they will have the ability to free-ride on the infrastructure of existing infrastructure owners, therefore reducing the costs of market entry.

Telstra believes that the efficient cost of building and operating the access provider's actual network is most likely to send this efficient build/buy signal. In Telstra's view, access prices need to be set with at least a greater degree of consistency with actual forward looking costs if efficient build/buy decisions are to be made. Such an approach will not only help ensure efficient build/buy decisions are made, it has

the potential to drastically reduce the administrative costs associated with access price determinations.

In contrast, TSLRIC as applied by the ACCC represents the costs of efficient bypass. However, if the incumbent facilities are priced at the cost of the most efficient alternative, efficient bypass is unlikely to occur. In Telstra's view, TSLRIC as applied by the ACCC marks down the returns on the incumbent's assets to the level that would be expected by the most efficient operator, but to a level that is also unlikely to induce infrastructure roll-out by market entrants. In effect, access seekers receive the price of the most efficient network - but then have no incentive to investment in infrastructure themselves.

From an efficiency point of view, competitors ought to build their own networks when the long run costs they will incur in doing so are below those the access provider will actually incur over the longer run. The costs that the access provider *ought* to incur, or more generally would incur if it were run with perfect foresight, are irrelevant to this calculation: the proper price signal should reflect commercial reality.

In this sense, all "efficient cost" standards distort build/buy decisions. However, the extent of this impact is magnified by the manner in which the ACCC has interpreted the standard, and the very low level of charges in which this interpretation results. Telstra believes that this is a significant factor in the observed pattern of competitive investment to date.

The reality is that at the margin, Telstra must allocate its funds among competing uses in the light not of the short term or immediate profitability of the grouping of services they support, but of their return over the lifetime of the assets being acquired. Even if it were the case that Telstra's PSTN was "profitable" in some economically relevant sense today, it is the future profitability of the service that counts; and the ever strengthening competition in this area, combined with continued heavy-handed regulatory intervention, hardly makes investment in the customer access network attractive when compared to alternatives.

No less importantly, the ACCC's decisions, by setting access charges below cost, cannot but distort and depress investment in regulated assets, as the return on that investment to Telstra is reduced below the return it yields to consumers and service suppliers as a whole. It is these impacts at the margin, rather than aggregate comparisons of costs and revenues, that are economically relevant.

It is not only Telstra's investment that is adversely affected. In Telstra's view, the artificially low charges being set by the ACCC for access to Telstra's facilities are also reducing the incentives for investment in competing facilities by Telstra's rivals, even when these competing facilities would have lower costs to society than Telstra itself incurs.

The costs this imposes in terms of foregone competition are obvious. It is also important to note that this creates a self-perpetuating burden of regulation: regulatory distortions prevent new facilities from being committed to the market; the fact that there are not such facilities is then used by the ACCC as being grounds for continuing to regulate.

Furthermore, the current legislative criteria to which the ACCC is required to have regard (when assessing or setting access prices) provide the ACCC with wide discretion in setting prices:

- There is no requirement that the ACCC set access prices to allow the access provider to recover efficiently incurred costs, including the costs it must incur in meeting legislated service obligations.

- There is no requirement for consistent application of pricing methodologies.

- There is no guidance on the weight to be placed on the different legislative criteria.

The result is that access prices can be set at levels that prevent firms from recovering efficiently incurred costs and hence can be inconsistent with economic efficiency, including efficient investment. There is also significant uncertainty over access prices going forward, again deterring investment.

Telstra notes that the Productivity Commission accepted many of these concerns in its 2001 Final Report. The Productivity Commission made an express recommendation to address some of these concerns with a view to promoting greater investment. The Productivity Commission recommended was as follows:

> "RECOMMENDATION 11.1
>
> The Commission recommends that a new section be included in Part XIC of the TPA.
>
> 1. The ACCC in seeking to reduce access prices that are inefficiently high, must also have regard to the following principles:
>
> (a) that regulated access prices should:
>
> (i) be set so as to generate expected revenue across a facility's regulated services that is at least sufficient to meet the efficient long-run costs of providing access to these services;
>
> (ii) include a return on investment commensurate with the regulatory and commercial risks involved;
>
> (iii) generate revenue from each service that at least covers the directly attributable, or incremental, costs of providing the service; and
>
> (iv) reflect any uncompensated costs associated with imposed community service obligations.
>
> (b) that the access price structures should:
>
> (i) allow multi-part tariffs and price discrimination when it aids efficiency; and
>
> (ii) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, except to the extent that the cost of providing access to other operators is higher.

(c) that access pricing should provide incentives to reduce costs or otherwise improve productivity.

2. Where there is a conflict between any pricing principle and the objects clause, (s. 152AB(1)), the objects clause has precedence."

The Productivity Commission's recommendation in 2001 has not yet been adopted. Telstra notes, however, that the Treasurer has announced his support for similar changes to Part IIIA.[15]

Telstra Corporation Limited

11 April 2005

[15] See http://www.treasurer.gov.au/tsr/content/publications/nationalaccessregime.asp, 20th February 2004.