



Optus Submission

**To The Senate Standing Committee on Environment,
Communications and the Arts
Telecommunications Legislation Amendment
(Competition and Consumer Safeguards) Bill 2009**

7 October 2009

Table of Contents

1.	Introduction	3
2.	Executive Summary	3
3.	A reform package that will enhance competition	5
4.	Criticism of the reforms are unfounded	10

1. Introduction

- 1.1 On 17 September 2009 the Senate referred the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 to the Senate Standing Committee on the Environment, Communications and the Arts for inquiry and report. The committee has called for submissions in connection with its consideration of the above issues. This submission is put forward on behalf of Optus.

2. Executive Summary

- 2.1 In April 2009, the Government issued a discussion paper titled “National Broadband Network: Regulatory Reform for 21st Century Broadband Discussion Paper” (“Discussion Paper”). This Discussion Paper recognised that the current regulatory arrangements in the telecommunications sector are ineffective, that they are not meeting their goals and as such are failing businesses and consumers. Accordingly, the Government indicated its intention to consider important reforms of the present regulatory arrangements and set out a number of options for the industry to provide comment on.
- 2.2 Optus provided a detailed submission in response to the Discussion Paper in which it agreed with the Government’s assessment of the current regulatory arrangements and state of competition in the fixed line market and argued for fundamental reform of the sector. Optus submitted that new regulations should be built around four key pillars¹;
- (a) The structural separation of Telstra’s access and retail businesses;
 - (b) The implementation of a clear equivalence of access obligation on Telstra to provide services to all access seekers (including Telstra Retail) on truly equal terms;
 - (c) To streamline the current regulatory rules and provide the ACCC with more effective powers to take targeted action; and
 - (d) Changes to the existing rules to better align access prices to the cost of providing services.
- 2.3 Optus argued that reforms implemented in line with these four pillars would go to the core of the current problems that have resulted in a dysfunctional fixed line market structure and a regulatory system that is mired in litigation. In particular, Optus argued that such reforms would lead to a paradigm shift in the regulatory framework that would deliver the necessary behavioural change and equality of access that are so vital for the development of sustainable competition in the fixed line services market. This would not only enhance the prospects for competition and therefore consumer outcomes in the short term, it would also create a platform for the industry to successfully transition to the new super fast technology of the National Broadband Network (NBN).
- 2.4 The reforms outlined by the Government in the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 fall into three broad categories:
- (a) Reforms to address Telstra’s vertical integration and market power;

¹ Refer Optus Submission Regulatory Reform for the 21st Century June 2009, http://www.dbcde.gov.au/_data/assets/pdf_file/0016/115405/Optus-Main.pdf

- (b) Measures to streamline the current regulatory arrangements and strengthen the powers of the ACCC to make decisions; and
- (c) Reforms to strengthen certain existing consumer safeguard provisions.

- 2.5 Optus considers that the proposed reforms under the first two items listed above are consistent with the four pillars approach proposed by Optus in its response to the Government's Discussion Paper. Optus is, therefore, **highly supportive** of the proposed reforms. If implemented in its present form, Optus considers that the reform package will provide the foundation for stronger competition to emerge in the fixed line sector.
- 2.6 These reforms will undoubtedly result in significant changes within the industry. There have inevitably been strong responses to the reform package, particularly in respect of the separation proposals. Predictable arguments have been raised that; separation does not work in practice; that it will create significant costs for Telstra; and, that it will reduce shareholder value. These criticisms do not stand up to scrutiny.
- 2.7 In respect of shareholder value, Optus notes that many industry analysts have retained their "Buy" recommendations on the Telstra stock following the Government's announcement predicting share price accretion over the next twelve months as these reforms are implemented. The claims relating to the costs of separation remain out of line with those experienced by BT in the United Kingdom, which successfully implemented a robust form of functional separation in 2006.
- 2.8 But more importantly, these criticism fail to acknowledge that the reforms have been well signalled and that they are aimed squarely at delivering improved outcomes for all Australians by putting the industry on to a more competitive basis. The experience of the UK and New Zealand demonstrate the benefits that separation brings in terms of delivering pro-competitive outcomes. In a recent assessment of the impact of the separation arrangements introduced by BT (through its voluntary separation undertakings), Ofcom has noted that²:

"While not the sole contributing factor to benefits experienced by consumers and businesses, we consider that the Undertakings have played a role in bringing about greater choice and take-up of services, choice of suppliers, products and packages and increased value for money. Competition has played an important factor in the take-up of fixed telecommunications services. Benefits include:

- *Increased take-up of new services and packages:*
- *Greater affordability:*
- *Increasing customer engagement with fixed telecommunications services*
- *Growing levels of switching in broadband:*
- *High levels of satisfaction."*

- 2.9 As the very many submissions to the Government's discussion paper have demonstrated, the need for reform is long overdue. It is important for industry that we now move forward quickly to implement the changes and ensure that all Australians can enjoy the benefits that increased competition will deliver. **Optus urges Parliament to pass these reforms as soon as possible.**

² Ofcom, Impact of the Strategic Review of Telecoms Implementation Review - Statement, 29 May 2009, page 4

3. A reform package that will enhance competition

- 3.1 This section sets out Optus' detailed perspective on the individual components of the Government's proposed telecommunications reform package. In particular, Optus highlights why these reforms are likely to create a more competitive environment for the provision of fixed line telecommunications services which in turn will deliver significant benefit for Australian consumers.

Separation arrangements for Telstra

- 3.2 The centre piece of the draft legislation includes measures to implement the effective separation of Telstra's wholesale/network activities from its retail activities. This may involve Telstra voluntarily proposing an arrangement for structural separation or it may involve the Government mandating functional separation of a type similar to that introduced in New Zealand and the United Kingdom.

- 3.3 Optus is strongly supportive of these measures. Many of the problems with the current market structure and the regulatory arrangements have their root cause in the vertically integrated structure of Telstra and the corresponding misalignment of incentives this creates. Telstra is one of the most vertically integrated incumbent carriers in the world, and has a dominant position in almost every market it operates in. However, it is as the dominant retail and wholesale supplier of fixed line services that Telstra's market power is most pervasive. This position of dominance gives Telstra strong incentives to act in a manner that discriminates against its competitors. Coupled with a weak regulatory system it has the opportunity to regularly act on these incentives to exploit its market power to the fullest possible extent. These problems were outlined at length in Optus' submission to the Discussion Paper.

- 3.4 Optus endorses the view put forward in the Second Reading Speech that the implementation of separation arrangements will go to the core of this problem:

"...the bill is designed to promote effective competition in the sector by addressing the underlying incentives Telstra has as a highly integrated company to favour its own retail businesses"³.

- 3.5 A network/wholesale operation which is either structurally or functionally separated from Telstra's existing Retail business will not have the same incentive or opportunity to favour Telstra's Retail business over other access seekers. Rather the separated network/wholesale unit will have strong incentives to treat all access seekers on equal terms as favoured customers, especially if these separation arrangements are supported by legally enforceable measures to prevent discriminatory dealing.

- 3.6 Such an outcome will undoubtedly help to level the playing field in the fixed line market, thereby delivering a significantly enhanced opportunity for competition to develop. The benefits of separation have been clearly recognised in the United Kingdom, where BT plc was required to implement functional separation in 2006. In a recent report for BT, SPC Networks has noted that:

"There was general agreement amongst the interviewees that whilst the implementation of equivalence and functional separation has not been perfect, it has brought about

³ Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009, Second Reading Speech, Minister for Infrastructure, Transport, Regional Development and Local Government, the Hon. Anthony Norman Albanese MP - 15 September 2009

*considerable improvements. Most importantly, downstream competitors of BT now have more confidence to invest, and indeed are doing so*⁴.

- 3.7 Further, in public hearings before the Senate Select Committee on the National Broadband Network earlier this year, Peter McCarthy-Ward, BT Director for the East of England, noted that in respect of the separation arrangements implemented by BT;

*“the results appear to be that the UK market is functioning well in a competitive sense, that BT itself has not been hampered or harmed in its own performance, and that competition is operating on a much fairer and more equitable basis, so the consumer and the end user appear to be benefiting as well”*⁵.

- 3.8 Perhaps the most compelling endorsement of separation is provided by Ofcom which, following a recent assessment of the impact of the separation arrangements introduced by BT, has concluded that separation has been successful in delivering improved competition in the UK. Ofcom has noted that:

“Since our last review, and nearly four years on since the Undertakings were given, our annual evaluation continues to indicate that the net effect of the Undertakings to date, both for competition and consumers has been positive.

*Given the substantial benefits the Undertakings have delivered to retail and wholesale customers to date, we continue to remain of the view that the Undertakings are an appropriate and comprehensive solution to the competition concerns that we set out in the TSR”.*⁶

- 3.9 Optus notes that these views by the UK’s independent regulator are in direct contrast to those contained in a recent report by the Brookings Institute⁷, which has been cited by one of the most vocal critics of the Government’s reforms, Dr Phil Burgess⁸. The Brookings Institute has recently released a “working draft” of a paper that brings into question the benefits of separation arrangements, including those implemented by BT. Optus has misgivings about the objectivity of the report since it was financially sponsored by a large incumbent US carrier, Verizon, with vested interests to protect. We also observe that one of the authors was engaged by Telstra to assist with its advocacy in a recent regulatory proceeding. Notwithstanding these concerns, the conclusions of the report should in any event be treated with extreme caution since they narrowly focus on changes in the rate of broadband growth and levels of investment both before and after separation was implemented. Neither of these appears to be compelling measures of competition effects and the analysis falls well short of that undertaken by Ofcom which looks at more meaningful factors such as take-up in absolute terms, affordability and customer engagement.

- 3.10 Indeed, such is Ofcom’s confidence in the separation and equivalence arrangements that now apply to BT, that it has felt able to reduce regulations in certain areas of the market. For example, Ofcom has removed a number of the retail price control arrangements that previously applied to BT⁹. Ofcom’s analysis clearly demonstrates that separation works.

⁴ SPC Networks “Equivalence of Input and Functional Separation: A Framework for Analysis, page 2

⁵ Senate Select Committee on National Broadband Network, Wednesday, 4 March 2009 Canberra

⁶ Ofcom, Impact of the Strategic Review of Telecoms Implementation Review - Statement, 29 May 2009, page 3

⁷ Vertical Separation of Telecommunications Networks: Evidence from Five Countries – Working draft paper by Robert W. Crandall, Jeffrey A. Eisenach, Robert E. Litan

⁸ Interview with Dr Phil Burgess, ABC Sunday Profile

⁹ Ibid, page 39

Horizontal separation of Telstra

- 3.11 The legislation has also included measures to achieve the horizontal separation of Telstra by inviting it to divest its interest in both its HFC network and its fifty per cent stake in Foxtel. These measures directly respond to concerns that Telstra's high-level of integration, which is unique by international standards, will enable it to leverage its dominance from telecommunications into related content markets (and vice versa) through its ownership stake in its cable network and Foxtel.
- 3.12 Again Optus is highly supportive of these measures. In its submission to the Discussion Paper, Optus highlighted concerns about the relationship between Telstra and Foxtel. Access to valuable content is likely to become an important force driving the take-up of higher speed broadband services. This creates a very real risk that a monopoly in premium content could be used to undermine future competition in broadband services. To address this risk Optus recommended that Government consider the divestiture of Telstra's ownership stake in Foxtel and access regulation in respect of premium content.
- 3.13 Optus notes that the provisions dealing with horizontal separation are ultimately discretionary and can be waived if the Minister is satisfied with the terms of Telstra's structural separation plan. On balance this approach appears reasonable, since much of the risk relating to the potential abuse of Telstra's market power rests on its ownership of the local fixed line infrastructure. Under a structurally separated arrangement Telstra would not control such infrastructure so its market power would be lessened. However, competition risks relating to future control of content on an exclusive basis will remain and it would be appropriate for these reforms to be further assessed as part of the review of access arrangements to the National Broadband Network.

Streamlining the access and anti-competitive conduct provisions

- 3.14 The Government has also proposed significant changes to the access regime contained in Part XIC of the Trade Practices Act. The aim of these reforms is to reduce the levels of dispute, provide for more timely and efficient outcomes, and increase industry certainty. Optus understands that the new regime is intended to be more broadly consistent with the access regimes that operate in other key infrastructure industries in Australia, such as gas and electricity, and the role of the telecommunications regulator and other international jurisdictions.

New ACCC powers

- 3.15 The central change is that the proposed legislation will abolish the present negotiate-arbitrate model, under which the terms and conditions of access to declared services were firstly required to be determined by negotiation between the service provider and access seeker, and only failing agreement through private arbitration by the ACCC.
- 3.16 In its place, the ACCC will be given the ability to make upfront determinations on price and non-price terms of access as follows;
- (a) the ACCC may determine upfront price and non-price terms and conditions to apply in general for a 3 to 5 year period;
 - (b) the Access Determination will apply to all access providers and access seekers of the declared service;

- (c) the ACCC will have the power to determine fixed principles to apply for a stated period which may extend beyond the duration of the Access Determination;
- (d) the ACCC will have the power to make binding rules of conduct for the supply of declared services which would apply either in addition to or as a variation of an Access Determination (such rules could address particular issues as they arise);
- (e) there will no longer be ordinary exemptions from access obligations and no ordinary access undertakings;
- (f) the ACCC will have the power to request a party that lodges a special access undertaking to vary the undertaking without having to lodge a new undertaking; and
- (g) merits review will not be available for ACCC decisions under Part XIC.

3.17 In its submission to the Discussion Paper Optus argued that the negotiate/arbitrate model under Part XIC has proven to be a failure. It has provided Telstra with both the incentive and means to game the system to its advantage, which has resulted in a merry-go-round of regulatory disputes, delay and legal challenges. Today almost all commercial negotiations end up in a dispute before the ACCC, with these disputes in turn appealed to the Australian Competition Tribunal or the Federal court. Optus, therefore, argued that the ACCC should be given stronger powers to set the upfront price and non-price terms and conditions of access.

3.18 Optus also argued for the removal of the provisions relating to the lodgement of ordinary access undertakings and merits based appeal processes, on the basis that each of these arrangements has been largely used to frustrate and delay the regulatory decision making processes.

3.19 Optus is, therefore, highly supportive of the proposed reforms since they directly address very real concerns we have raised in respect of the existing regulatory arrangements. These reforms have the clear potential to transform the current regulatory processes by removing the legal strait jacket within which the ACCC has to operate today. The new provisions should enable the ACCC to better fulfil its role in promoting outcomes that are in the best long term interests of all Australian consumers and businesses.

Anti-competitive conduct

3.20 The provisions of Part XIB of the Trade Practices Act set out anti-competitive conduct rules that are specific to the telecommunication sector. These provisions were intended to achieve a timely resolution of allegations of anti-competitive conduct. However, the effectiveness of the Competition Notice procedure has been brought into question, because of the obligation for the ACCC to engage in a consultation process and the scope for legal challenge on procedural fairness grounds.

3.21 The proposed legislation will address these concerns by removing the requirement for the ACCC to undertake consultation prior to issuing a competition notice. Optus is supportive of this change.

3.22 The Government also proposes to clarify that Part XIB applies to content services, in order to increase regulatory certainty and reduce the risk of protracted legal disputes on this issue. Again Optus is supportive of the proposed amendment. As indicated in the Explanatory Memorandum to the Bill recent advances in technology have increased the capacity for carriers and carriage service providers to provide content services that are valued by customers. The opportunity exists for content especially that acquired on an

exclusive basis, to be used for anti-competitive purposes through bundling with telecommunication services. It is appropriate, therefore, that content should be subject to the anti-competitive conduct provisions.

Strengthening the Consumer Safeguard provisions

- 3.23 The Government has also proposed to strengthen a number of the existing provisions which protect consumer interests, such as the Universal Service Obligation and the Consumer Service Guarantee. Whilst many of the detailed changes will be determined at a later date, Optus is supportive of the principle underlying the proposed reforms.

4. Criticism of the reforms are unfounded

4.1 Since the Government's announcement a number of parties have criticised the reform package. These criticisms typically fall into three categories; that the reforms are not needed; that their implementation will result in significant costs to Telstra, and; that these reforms will destroy Telstra shareholder value. In this section Optus responds to each of these claims which are largely without merit.

The reforms are necessary

4.2 In its immediate response to the reform package and in subsequent public statements Telstra has argued that *"many aspects of this package are unnecessary and need never be implemented if a mutually acceptable outcome can be reached on the National Broadband Network"*. Optus submits that this is at best a disingenuous statement and is close to being misleading.

4.3 Firstly, it quite clearly flies in the face of the very many submissions in response to the Discussion Paper that argued for significant reform of the existing telecommunications regulations and in particular the need for some form of separation of Telstra. Notably this included a very lengthy and considered submission from the independent regulator, the ACCC, which argued for the structural separation of Telstra as a necessary reform as the industry transitions towards the NBN. The ACCC has stated that:

"The ACCC is of the view that structural separation of Telstra is the only framework that will ensure equivalence in access during the transition to the NBN and is the only form of separation consistent with the type of wholesale–retail market structure the Government envisages for the NBN environment of the future.

The current operational separation regime is not an appropriate structural arrangement for Telstra during the transition to the NBN. Furthermore it is inconsistent with the structural framework envisaged for the future NBN environment and will not assist in facilitating opportunities for competitive outcomes in the transition period".¹⁰

4.4 Secondly, Telstra's rhetoric is at odds with its actions. It is effectively asking the Minister to "trust it" to come to a conciliatory agreement on reform. Yet this is the company that has spent the past three years railing against further regulations in the most belligerent fashion. Notwithstanding its change in management, Telstra's opposition has continued with its response to the Discussion Paper advocating the roll-back of the existing regulations and for the ACCC to be side lined. Whilst Telstra's language appears to be more measured and conciliatory, the more aggressive attack against Government has been taken up by its former close associates.

4.5 Telstra has had ample opportunity to reach an accommodation with the Government and has consistently spurned such opportunities. As outlined earlier in this submission, the proposed reforms are vital to the future of competition in this sector. These reforms need to be enshrined in regulation and not left to the grace and favour of Telstra.

Costs of separation

4.6 There have been predictable claims that the Government's proposed separation arrangements will entail significant costs for Telstra. In its recent full year results presentation, Telstra stated that the costs of implementing separation could involve one-

¹⁰ ACCC Submission to the Department of Broadband, Communications and the Digital Economy "National Broadband Network: Regulatory Reform for 21st Century Broadband" June 2009

off costs of \$800 Million to \$1 Billion with ongoing costs of \$50-\$100 million a year¹¹. Again, Optus notes that these claims do not stand up to scrutiny.

4.7 Optus does not dispute that implementing structural separation will involve costs to Telstra. Costs will undoubtedly arise from the reorganisation of Telstra, the need to improve present systems, products and services.

4.8 However, these costs are unlikely to be anywhere near as much as Telstra has claimed. Optus notes that BT, which is a considerably larger company than Telstra¹², incurred costs of £153 Million in implementing a very detailed and robust form of functional separation (this is very much less than the Billion dollars cited by Telstra).

4.9 In any event, such costs only form one part of the equation and should not be looked at in isolation. In particular, it is important to recognise that significant consumer benefits are likely to arise from the implementation of regulatory reform. In a report for Optus, Dr Chris Doyle of Warwick University presented a theoretical cost vs benefit analysis of the implementation of separation in the UK. From this analysis Dr Doyle makes the firm conclusion that;

“despite the large up-front costs associated with functional separation in the UK, there need only be modest gains on the demand side for the impact to be net-positive overall”.
¹³

4.10 Similarly, SPC Networks note that whilst there are likely to have been costs borne by BT in implementing functional separation this is only part of the equation and account needs to be taken of the fact that:

*“(i) there are not only costs but also savings which can accrue to operators and (ii) such costs should be set against consumer gains from dynamic efficiency.”*¹⁴

4.11 In many respects the costs to be incurred in implementing separation will simply be displacing costs the industry incurs to date operating under the present regulatory arrangements. In recent years the industry will have incurred costs of no less than \$200 million operating within the present regulatory arrangements. Yet, as noted earlier in this submission, these arrangements continue to fail Australian consumers and businesses.

Separation is not the armageddon scenario some have suggested

4.12 A final criticism of the reform package is that it will destroy value for Telstra shareholders. It is not Optus' role to speculate on Telstra's share price, however, we do observe that the market reaction to the announced package of reforms has been fairly muted with Telstra's share price recovering after an initial small drop.

4.13 More significantly, Optus notes that many industry analysts have retained their “Buy” recommendations on the Telstra stock following the Government's announcement and predict share price accretion over the next twelve months as these reforms are implemented. This is demonstrated by the following table, which summarises Analyst

¹¹ John Stanhope, Telstra CFO – Transcript from Full Year 2009 Financial Results – Analyst Briefing, page 51

¹² BT's revenue is AUS\$42 Billion compared to Telstra's of AUS\$25.6 Billion. BT has 107,000 staff compared with Telstra's 39,464.

¹³ Comments on the Telstra Submission on Vertical Integration and Separation – A report for Optus, Dr Chris Doyle, page 17

¹⁴ SPC Networks, “Equivalence of Input and Functional Separation: A Framework for Analysis”, page 37

recommendations and target prices for the Telstra stock following the announcement of the reforms.

Post 15 Sept 09 Announcement				
Broker	Date 15/9/09-2/10/09	Target Price		Recommendation
GSJBWere	15-Sep-09	▶ \$4.40	▶	Buy
Merrill Lynch	15-Sep-09	▶ \$3.80	▶	Buy
Macquarie	16-Sep-09	▶ \$3.60	▲	Outperform
Deutsche	15-Sep-09	▼ \$3.70	▶	Buy
JP Morgan	16-Sep-09	▶ \$3.39	▶	Neutral
Credit Suisse	02-Oct-09	▶ \$3.80	▶	Outperform
Citi	25-Sep-09	▶ \$3.40	▶	Hold
UBS	15-Sep-09	▶ \$4.55	▶	Buy
RBS	15-Sep-09	▶ \$4.50	▶	Buy
Morgan Stanley	15-Sep-09	▼ \$3.78	▶	Overweight
Nomura	15-Sep-09	▶ \$3.21	▶	Reduce

4.14 Once again the facts do not stand up to scrutiny.

Conclusion

4.15 Optus has demonstrated that many of the criticism levelled at the reform package do not stand up to detailed scrutiny. As set out earlier in this submission the need for reform is long overdue. It is important for industry that we now move forward quickly to implement the changes and ensure that all Australians can enjoy the benefits that increased competition will deliver. Optus urges Parliament to pass these reforms as soon as possible.