

Investors Mutual Limited
Submission to the Senate Standing
Committee on Environment,
Communications and the Arts
Telecommunications Legislation Amendment
(Competition and Consumer Safeguards) Bill 2009

7 October 2009

EXECUTIVE SUMMARY

1.0 The Government Policy Does Not Address the Long Term Interests of Australian Consumers

The proposed amendments to the Telecommunications Legislation Amendment Bill

- Are heavily biased to achieving the short-term goal of competition (against Telstra) and will not promote future investment in the industry
- May restrict Telstra from acquiring new wireless spectrum which has unintended consequences of reducing competition and investments.
- Do not promote the long-term interest of Australian consumers under the objectives of the Trade Practices Act.

2.0 Structural Separation Does Not Work for Some Industries

- The Australian telecommunications and electricity industries support vertically integrated companies because their industries exhibit:
 - (i) significant capital costs specific to the asset owner and
 - (ii) high levels of complexity or uncertainty
- Structural separation in these type of industries in the long term will result in:
 - (i) higher prices for consumers,
 - (ii) significant resource wastage and/or
 - (iii) significant underinvestment
- Vertical integration in the Australian telecommunications and electricity industries has lead to continued investment and upgrading of products and services
- Economic literature provides strong support for vertical integration
- Market evidence provides strong support for vertical integration

3.0 The Government Cannot Second Guess Free Market Forces

- NBN does not resolve the incentive by the network owner to invest in the long term
- Rigorous cost-benefit analysis of the planned NBN is limited
- Commercial returns on NBN are highly speculative
- Despite its superior technology, FTTH in North America has low initial take-up rate indicating consumer demand is low
- Misjudging consumer demand is the critical reason why most commercial infrastructure projects fail
- If the NBN turns out to be a 'white elephant' a generation of Australians will hold the Labour Government responsible
- A vertically integrated company like Telstra is in an best position to determine when there is adequate consumer demand in order to make the required fibre investment

4.0 Conclusion

- The Government should aim for a sensible Telecommunications regulatory policy that creates a healthy balance between competition and new investment in the industry
- The current proposals of structural / functional separation and NBN are too biased towards the short term goal of competition but in the long term will lead to higher prices for consumers and lower investments across the industry.

This submission is put forward on behalf of Investors Mutual Limited (IML). It highlights several key problematic issues with the proposed Telecommunications Legislation Amendment Bill 2009.

1.0 The Government Policy Does Not Address the Long Term Interests of Australian Consumers

The Australian Government's objectives, as outlined in the Explanatory Memorandum, are clearly focused on competition via structural separation, functional separation, or divestment of Foxtel and the HFC network by Telstra, but lack the encouragement for future investments in telecommunications infrastructure.

"[Government's] *intended outcome is a healthy competitive market...*"¹

"...*functional separation is being proposed ... to promote transparency and equivalence to encourage the development of retail-level competition and broadband take-up.*"²

The Trade Practices Act (TPA) objectives are more defined. Part XIC, s152AB, of the TPA states that its objective is to promote the long-term interests of end users where it "must have regard" to the achievement of the following sub-objectives:

- promoting competition in carriage services;
 - which must have regard to removing obstacles impeding end-users access to carriage services but may also have regard to other matters
- achieving any-to-any connectivity across carriage services;
- encouraging the economically efficient use of and investment in infrastructure; which must have regard to,
 - technical feasibility (technology, reasonable costs and operational performance)
 - the legitimate commercial interests of the supplier (including scale and scope)
 - investment incentives (where relevant matters are not limited)
 - risks involved in making investment

It is clear that the draft legislation when lined up against the objectives of the Trade Practices Act may meet some of the objectives for competition but lacks a focus on investment in the industry.

¹ The Parliament of the Commonwealth of Australia House of Representatives, *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 Explanatory Memorandum*, 2009, pp. 21

² The Parliament of the Commonwealth of Australia House of Representatives, *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 Explanatory Memorandum*, 2009, pp. 31

Further, the Government proposal to restrict Telstra from acquiring new wireless spectrum is also at odds with the objectives of the TPA of promoting competition and encouraging investment.

The Australian mobile market is extremely competitive with three major players. In early 2009 the number three and four players Vodafone Australia and Hutchison merged. The mobile market shares for the three mobile players are estimated to be 43%, 31%, 26% for Telstra, Optus, and Vodafone/Hutchison respectively. This level playing field will be destroyed if Telstra is restricted from acquiring new wireless spectrum. Not only will the level of competition reduce, investments will also reduce as only two, not three, industry players will have the rights to invest in the new wireless spectrum.

SUMMARY

The proposed amendments to the Telecommunications Legislation Amendment Bill

- Are heavily biased to achieving the short-term goal of competition (against Telstra) and will not promote future investment in the industry
- May restrict Telstra from acquiring new wireless spectrum which has unintended consequences of reducing competition and investments.
- Do not promote the long-term interest of Australian consumers under the objectives of the Trade Practices Act.

2.0 Structural Separation Does Not Work for Some Industries

It is common knowledge that healthy competition is achieved in a free market by companies developing new products and services to give consumers greater selection and better products. The process of competition allows the free market to allocate productive resources to their most highly-valued uses and results in minimal resource wastage.

Economic theory, which is supported by empirical studies, show that resources are better allocated by vertically integrated companies in industries which exhibit the following characteristics:

- (i) significant capital costs specific to the asset owner
- (ii) high levels of complexity or uncertainty

Both these characteristics are clearly prevalent in the Australian telecommunications and electricity industries.

The ACCC in its submission provided Australian examples of voluntary structural separation including

“ ... in 2005, the Australian Gas Light Company split its infrastructure assets ...
... in 2007, Toll split off its infrastructure assets ... ”³

The ACCC’s objective of strengthening competition has failed to recognise the different nature of telecommunication network assets versus gas pipelines or ports. Even though all these three assets require the commitment of billions of dollars in assets that are highly specific to the owner, the underlying technologies for gas pipelines and ports are very stable and well known. On the other hand, the telecommunications industry has a high degree of uncertainty and complexity associated with continued technological innovation which affects the network assets. Innovation and continuous investment is imperative in the Telecommunications industry.

This rapid pace of technological change means that if the network assets are structurally separated, prices between the network owner and retail service providers will have to be higher to mitigate the high degree of uncertainty and complexity⁴. Of course, prices can be regulated lower by Government authorities but this will also force the network owner to slow network investment because of the lower risk adjusted rate of return for new investments.

Hence, in industries that face significant uncertainties only vertically integrated firms are the most economically efficient allocator of resources. The Committee should be aware

³ The Parliament of the Commonwealth of Australia House of Representatives, *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 Explanatory Memorandum*, 2009, pp. 12

⁴ For more detail on the benefits of vertical integration see Ergas, *Vertical Integration, Vertical Separation and Efficiency Consequences of the G9 SAU*, 2007

that structural separation will make the telecommunication industry more inefficient and resources will not be allocated correctly as required.

In the long term this will result in:

- (i) higher prices for consumers,
- (ii) significant resource wastage and/or
- (iii) significant underinvestment.

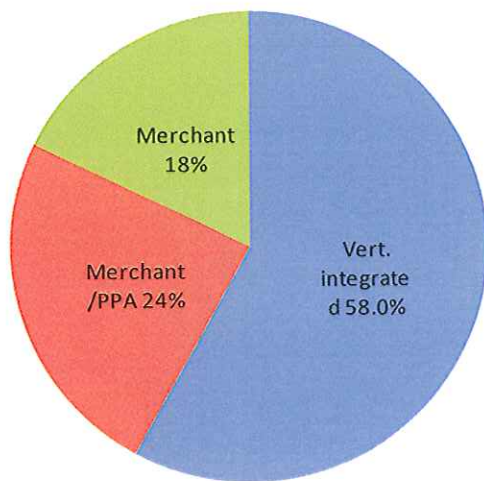
2.1 Vertical Integration in the Australian Electricity Industry has led to New Investments

Since the 1990's there has been a significant increase in vertical integration in energy retailing, power generation and gas exploration and development. All major utility companies such as AGL, Origin Energy, TRU Energy, and International Power are all pursuing strategies of vertical integration.

The primary objective of vertical integration in the electricity industry is to efficiently manage the uncertainty around wholesale price and volume risk. Even though the technology associated with electricity generators is relatively stable, wholesale prices are extremely volatile. The wholesale price volatility is mitigated under a vertically integrated structure.

Once wholesale price and volume risk can be managed, the companies are in a better position to assess what new investments are required. This vertical integration has been crucial for investment in new power generation investments. Since 2000, more than half of the private investment in power generation (excluding wind) has been undertaken by Australia's vertically integrated utility companies.

Figure 1: Investment in Power Generation Since 2000



Source: Owen Inquiry into NSW privatisation, Company announcements.

The billions of dollars in investment required to build electricity generation plants would less likely have occurred if Australian utility companies did not have the objective of becoming more vertically integrated. Given that State and Federal Government funding for generation assets is limited, the private sector is increasingly sought after to provide these investments which will benefit the companies making these investment and importantly these investments will improve the services to the community.

2.2 Vertical Integration in the Australian Telecommunications Industry Leads to New Investments

Over the last few years, Telstra's horizontal and vertical integration has resulted in major new investments:

2.2.1 3G Mobile Network:

In 2004, Telstra announced plans to invest about \$1.1 billion on a new 3G network. TLS has since spent another \$400 million on the new mobile network. Since its launch in 2006, it has received a number of awards including the 2008 Best Mobile Carrier at Telecoms Asia awards that recognises it as a world class mobile network. Telstra's innovation has resulted in a 3G mobile network that offers the highest speeds and has the greatest population coverage at 99% compared to its competitors. In fact, Telstra's 3G network was a world first for national coverage.

2.2.2 HFC upgrade:

In March 2009, Telstra announced that it will invest about \$300 million in upgrading its HFC network in Melbourne. The upgrade will increase the peak download speeds to 100Mbps to 1 million Melbourne homes. The speeds offered on the HFC network in Melbourne will be the fastest in the nation on a mass market basis.

Despite Telstra's investments in the sector, a common criticism by the ACCC is that Telstra's market share is too high and that competition is not working.

*"The ACCC has recently reported that competition in the Australian telecommunications market is not emerging as anticipated."*⁵

High market share without product innovation or investments is a cause for concern. However, industries that support vertically integrated companies inevitably result in high market shares. Both the Australian telecommunication and electricity industries share similar industry dynamics whereby new investments entrench the incumbent's market position. In regards to Telstra, it was due to the response of competition (rather than the lack of competition) that the company invested in its network to increase its market share

⁵ The Parliament of the Commonwealth of Australia House of Representatives, *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 Explanatory Memorandum*, 2009, pp. 22

in retail fixed broadband SIO from 42% in 2004 to 46% in 2009. The increase in market share is the result of Australian consumers responding to the better services offered by Telstra, not due to any abuse of market power by Telstra. Many Australian consumers have benefited from Telstra's innovation. Stating that Telstra's increased market share is due to market power abuse is misleading in a highly competitive market like Australia.

Further, Optus (Australia's second largest telecommunication company) can easily increase their retail fixed line market share by offering services on its own HFC network which passes 2.2 million Australian homes. Instead, under current regulation, it is more profitable for Optus to buy wholesale services as priced by the ACCC from Telstra's network.

2.3 Economic Literature Provides Strong Support for Vertical Integration

LaFontaine and Slade (2007) provided an extensive review of the economic literature (almost 200 research papers) on the effects of vertical integration. Their results show that the empirical evidence supports the theoretical underpinnings of vertical integration.

*“ ... under most circumstances, profit-maximising vertical-integration and merger decisions are efficient, not just from a firms' but also from the consumers' points of view. Although there are isolated studies that contradict this claim, the vast majority support it.”*⁶

2.4 Market Evidence Provides Strong Support for Vertical Integration

Market commentators, such as Morgan Stanley, have provided research that indicates that if the network assets were spun-off the value of two separate companies will be more highly valued by the stock market. This is highly speculative and their analysis focuses on the short-term. It does not address the long-term interest of consumers by answering the key question: who is going to upgrade the network in the long-term when there is limited incentive to do so by the network owner?

Only a vertically integrated telecommunication company can best resolve this long-term issue.

If the theory of breaking up the network assets from the retail customer base had any logic, we would have witnessed a wave of structural separation for telecommunication assets occurring globally. Not one telecommunication incumbent has voluntarily offered to spin off its network assets.

The only exception that came close to voluntary structural separation was Eircom, the national incumbent in Ireland. The motivation behind the split was driven by the short-

⁶ Francine LaFontaine and Margaret Slade, *Vertical Integration and Firm Boundaries: The Evidence*, 2007 *Journal of Economic Literature* 45; 3, 629-685.

term interest of private equity (Babcock Capital management, BCM). The main stumbling block was that the Irish regulator indicated it would reduce the allowance for cost of capital of the network assets. BCM shelved their plans for separation in 2008 after pursuing it for two years.

SUMMARY

- The Australian telecommunications and electricity industries support vertically integrated companies because their industries exhibit:
 - (iii) significant capital costs specific to the asset owner and
 - (iv) high levels of complexity or uncertainty
- Structural separation in these type of industries in the long term will result in:
 - (iv) higher prices for consumers,
 - (v) significant resource wastage and/or
 - (vi) significant underinvestment
- Vertical integration in the Australian telecommunications and electricity industries has lead to continued investment and upgrading of products and services
- Economic literature provides strong support for vertical integration
- Market evidence provides strong support for vertical integration

3.0 The Government Cannot Second Guess Free Market Forces

3.1 NBN Does Not Resolve the Incentive by the Network Owner to Invest in the Long Term

Under structural or functional separation, there is less incentive for the network owner to invest in the network. To bypass the incentive of upgrading the existing network by Telstra if it is structurally or functionally separated, the Government has proposed to build a National Broadband Network (NBN) to cover 90% of the population.

This still does not resolve the issue of whether it is in the long term interest of consumers. Whether it is the copper network (Telstra's network) or fibre network (NBN) separated from the retail customer base, the network would still charge a high price because uncertainty still exists around technological risk. Further, if prices are lowered due to Government regulation the incentive to upgrade of the networks is severely hampered.

The Government has cited that functional separation has worked well for BT, the British telecommunication incumbent, because it has increased the level of competition in the UK industry. However, the UK's heavy handed regulation had the unintended consequence of slowing down BT's investments in their fibre network. In response, Ofcom, UK's telecommunications regulator is consulting with the industry to change the regulation so that it encourages investments. Ofcom have made the following statement:

*"... we need to make sure existing regulation is relevant to rapidly changing market circumstances. This is why we are consulting on a related change to the Undertakings agreed by BT with Ofcom in 2005 that will promote efficient investment in super fast broadband networks and services."*⁷

3.2 Is there Demand for NBN and Can a Commercial Return be achieved?

After the failed process of not getting a satisfactory outcome on the fibre-to-the-node (FTTN) proposal to deliver 12 Mbps to 98% of the population, the Government in April 2009 proposed to build a fibre-to-the-home (FTTH) network called the National Broadband Network (NBN). This new proposal aimed to deliver 100 Mbps to 90% of the population with the Government owning at least 51 per cent of the new network.

The Government also stated that NBN would seek equity from the private sector to co-invest. Hence, NBN would not exist without private sector funds, which would certainly demand high risk adjusted returns from such a project. Three submissions to the Select Committee on the NBN to date have provided clues on the commercial returns and its underlying assumptions.

⁷ Ofcom, *Delivering Super-fast Broadband in the UK: Promoting Investment and Competition*, 3 March 2009, pp1

Table 1. NBN Commercial Returns and Assumptions

	Wholesale Access Price	Household Take-Up	Capital Cost	Return
Deutsche Bank	\$30	65%	\$27.7bn	n.a.
Optus	\$50	60%	\$43bn (top end)	n.a. (viable)
Southern Cross Equities	\$70	70%	\$43bn	10%

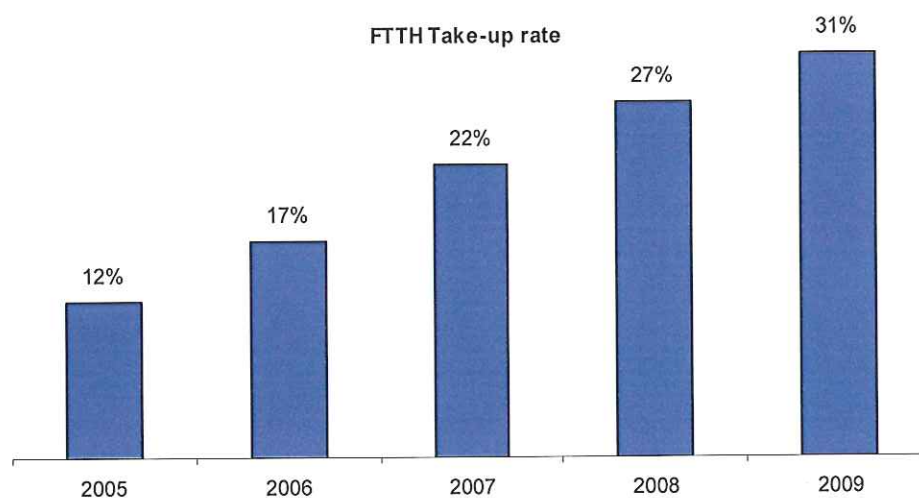
Source:

- *Chopra and WongPan, Deutsche Bank, Telstra Corporation: Valn Discount Likely to Persist – Downgrade to Hold, May 2009*
- *Optus, Optus Submission to the Senate Select Committee on the National Broadband Network, July 2009*
- *Southern Cross Equities, Southern Cross Equities Submission to the Senate Select Committee on the National Broadband Network, July 2009*

Deutsche Bank does not provide the returns for the NBN project. Optus and Southern Cross Equities highlight that the NBN is viable at higher wholesale access prices. To earn a commercial return on NBN, the Government needs to finely regulate the wholesale access price to entice consumers to switch from the copper network to the new fibre network. If the price is set too low or too high a commercial return will not be achievable. The above comparisons highlight how highly speculative the NBN project is based on the wide range in outcomes on wholesale access prices.

Furthermore, the underlying assumption of 60% household take-up rate is a huge leap of faith for the NBN to make a commercial return. Based on North American evidence, where FTTH is rolled out progressively, it shows that it can suffer from low initial take-up rate.

Figure 2. North American Evidence on FTTH Take-up Rate



Source: *Fiber-to-the-Home Council North America: North American FTTH/FTTP Status*

Over the last five years the take-up rate for FTTH has increased on average by 5% per annum from 12% to 31%. Assuming the same 5% increase in take-up rate per annum going forward it will take another 6 years to reach 60%. Hence, it could take 11 yrs for the take-up rate to increase from 12% to 60% in North America.

Despite being a superior technology, there has been no overwhelming demand from North American consumers to mass migrate from other networks to FTTH. Furthermore, Australian demand for NBN may be even less, given that most of the internet and media content we watch and read are specifically designed for the North American consumers that cover events such as baseball, basketball and American football.

Although many commentators have cited the economic benefits of NBN, firm evidence of whether Australian consumer demand exists and if they are willing to pay for super high speeds is sparse. Specifically, there has been limited thorough cost-benefit analysis published. The exception is the Ergas and Robson (2009) report which provides a comprehensive cost-benefit assessment of the NBN⁸. Their findings indicate that in present value terms, its costs exceed its benefits by somewhere between \$14 billion and \$20 billion, depending on the discount rate used.

Without a rigorous cost-benefit analysis, the 'build and they will come' attitude for the NBN may result in a significant waste of resources and capital which could be used for other needed projects such as new hospitals or schools. This type of 'build and they will come' attitude has seen many infrastructure projects fail in the commercial arena. In the telecommunications industry, misunderstanding customer demand and their willingness to pay has resulted in the failure of NextGen and Comindico in the early 2000s. More recent examples of infrastructure failures have been the road projects in Sydney where both the Cross City Tunnel and the Lane Cove Tunnel have been put into insolvency because the traffic was significantly below demand expectations.

The stakes are even higher for the NBN, because it is the largest single project the Government has ever committed to, which will be partially funded using tax payer funds. We have already witnessed that misjudging consumer demand is the critical reason why most commercial infrastructure projects fail. In the commercial sector, the capital markets have a choice to invest in projects and have no one to blame but themselves if the project fails. On the other hand, tax payers do not have a choice on where the Government spends its funds. If the NBN turns out to be a 'white elephant' a generation of Australians will hold the Labour Government responsible.

Only a vertically integrated company like Telstra is in the best position to determine when there is adequate demand to meet the investment required to produce new products and services. The Government or structurally separated companies are not in a position to fully assess and respond to free market forces in the Telecommunications industry and any such notion should be firmly resisted.

⁸ Henry Ergas and Alex Robson, *The Social Losses from Inefficient Infrastructure Projects: Recent Australian Experience*, 2009

SUMMARY

- NBN does not resolve the incentive by the network owner to invest in the long term
- Rigorous cost-benefit analysis of the planned NBN is limited
- Commercial returns on NBN are highly speculative
- Despite its superior technology, FTTH in North America has low initial take-up rate indicating consumer demand is low
- Misjudging consumer demand is the critical reason why most commercial infrastructure projects fail
- If the NBN turns out to be a 'white elephant' a generation of Australians will hold the Labour Government responsible
- A vertically integrated company like Telstra is in an best position to determine when there is adequate consumer demand in order to make the required fibre investment

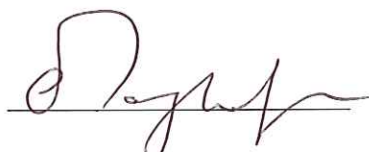
4.0 CONCLUSION

The Government should adopt a sensible Telecommunication regulatory policy that encompasses:

- (i) a healthy balance between competition and investments that can adapt to technological change
- (ii) the encouragement of investments in the commercial sector. The policy needs to recognise that:
 - a. Australian population density is very low in global standards which has a natural tendency to lead to higher prices
 - b. Vertical integration of an incumbent is important to keep prices lower and this company is in the best position to determine when investments can be made to meet any unsatisfied consumer demand.

The current proposals of structural / functional separation and NBN are too biased towards the short term goal of competition but in the long term will lead to higher prices for consumers and lower investments across the industry. These unintended consequences cannot be reversed in the future.

The current Government proposals are not in the best interest of Australian consumers in the long term.



Anton Tagliaferro

Investment Director



Jason Teh

Portfolio Manager / Analyst