Submission to Telecommunications Amendment Legislation Inquiry

October 2009

Introduction and Overview of the Urgent Need for Reform

The CCC strongly supports the Government's legislation to reform competition policy and regulation in telecommunications. The measures proposed are a long overdue and urgently needed response to problems that have been inherent in the policy shaping the industry since 1991.

Within that context, the CCC has a number of suggestions that it believes can improve the legislation while remaining true to the Government's intention. Some changes proposed are intended to improve or clarify regulatory tools. Some are intended to improve processes through clarifying requirements for transparency, without unduly sacrificing timeliness in implementing changes that are necessary for consumers and competitors.

There is enormous detail in the Bill, affecting most aspects of the regulation of the industry. This is necessary because the flaws in the present arrangements are so profound and have had such deleterious effect on consumers and competition for so long. Given the scope of the changes it is not surprising that there are some places at which the CCC submits the legislation can be improved through relativity minor changes.

However, this is detail and at the margin. The CCC submits that the crucial consideration for the Parliament should be that this Bill represents essential and overdue reform.

Further, there is grave danger that consumer and competitor interests will suffer yet more harm if there is delay in the passage of the legislation. This is illustrated by the most recent data on the state of the industry.

Competition in telecommunications is dangerously sick. Without fundamental reform, it is likely that it will die in some places, particularly in regional Australia where it has always struggled to gain a toehold.

Concentration in telecommunications has increased markedly in recent years. The result has been an explosion in consumer dissatisfaction and uncompetitive prices by international standards that has directly paralleled Telstra's increasing use of its market power and the consequential increase in concentration.

Data in the explanatory memorandum sourced from the ACCC demonstrates how dangerously concentrated all Australian communications market are, 12 years after reforms intended to implement full competition. Fixed line PSTN (Public Switched Telephone Network) services and Broadband Services are highly concentrated and becoming more concentrated, 12 years after the introduction of policies to open telecommunications to competition.

Data from recent Telstra annual reports further shows how quickly competition has retreated in recent years.

In the past three years there has been a fall of 290,000 individual consumers lines connected to competitors. This is a fall of 12.75% compared to a loss of 0.6% of basic access lines by Telstra Retail in the same period.

The loss of competitors' lines is a consequence of competitors being forced off wholesale line rental services because they are uneconomic. Further, this means that it is consumers in regional locations who are worst affected by the loss of competition. These are the consumers most likely to rely on wholesale line rental service to support any competitive entry into their communities.

It should not be a surprise that there has been an upsurge in consumer complaints in recent years as competition has foundered. Complaints to the Telecommunications Industry Ombudsman have increased almost three fold to about 150,000 individual complaints recorded in the five years to 2008.

Clearly, this is a situation that has reached crisis point. It has been clear for many years that the present arrangements to create competition in telecommunications have failed to make a serious impact on Telstra's privileged position as the former publicly owned monopolist.

It has also been very clear what needs to be done. The time to act is now, before further irreparable harm is done to competition.

The CCC is aware that some have argued that the legislation should not address structural issue because a regulatory solution could be found if there was "good will" on all sides.

This, however, illustrates the problem exactly. Telstra can choose to act within the spirit of the law, but if it chooses not to, the law is incapable of constraining it from acting in ways that are completely contrary to the policy intention and damaging competition and consumer interests.

There have also been complaints that Telstra shareholders have somehow been betrayed. The CCC submits that these complaints cannot be taken seriously for several reasons;

- Every Telstra sale tranche acknowledged the simple reality that the regulation of telecommunications was subject to change
- Telstra shareholders are asking to have interests protected that are immeasurable. It is impossible to know what regulatory action might result in Telstra share movements over time. Functional separation of BT was followed by share growth, while Telstra's value has declined precipitously in recent years while it was brutally exercising market power

- It is not the Government's responsibility to protect the interests of the shareholders of one company over the interests of other companies' shareholders, and certainly not ahead of the interests of all citizens who have paid inflated prices for crucial communications services because of Telstra's unconstrained monopoly power.

Perhaps most ridiculous are claims that international views about the sovereign risk involved in doing business in Australia would be affected negatively by this legislation. The CCC has seen no evidence of a flight of capital or additional risk premium being applied to the UK and New Zealand since they took similar action.

In short, the arguments that Telstra shareholders need to be protected are pure short term self-interest that takes no account of the fact that these shareholders have benefited from 12 years of inflated returns at the expense of all Australians who pay inflated prices.

The rest of this submission is separated into parts dealing with the proposed legislation in two broad parts. The first is the parts of the legislation that deals with creating the crucial structural changes in the industry to create incentives for the network owner that are sympathetic toward competition rather than antagonistic. This part deals with both the functional separation provisions and the structural separation provisions.

The second parts of this submission deals with some of the changes proposed to the regulatory tools and tasks that are provided for to allow the ACCC to regulate conduct and activity within this new industry structure.

Industry Structure Elements of Legislation

It has become clear that the only way in which telecommunications in Australia would move to a sustainably competitive footing would be for the Government to move to separate the control of the monopoly network from the control of the same management of the largest retailer. The ACCC has repeatedly since 2003 argued that Telstra has both the incentive and the ability to discriminate in favor of its own retail interests by making it more difficult or more expensive for other companies to use the monopoly network elements. The CCC and its members have over the years provided dozens of examples of this type of conduct.

The CCC believes that the proposals by the Government have the potential to correct this problem. The legislation explicitly describes a framework for functional separation. Separately, it outlines a process by which Telstra could voluntarily structurally separate.

Functional Separation

Minimum Principles for Functional Separation to Work

As the ACCC has said, the only way to remove the incentive on Telstra to discriminate against competitors is to structurally separate its wholesale and retail businesses. However, a functional separation regime that has strong enough rules and boundaries between wholesale and retail could conceivably quarantine the incentive and manage the ability to discriminate.

The explanatory memorandum to the legislation provides a good starting point in describing what will be the requirements of Telstra's functional separation plan if it chooses to remain structurally integrated.

The CCC understands that the exact requirements will be presented as a Ministerial Determination. However, the CCC submits that some additional detail in the legislation around the principles that will guide the determination is important. These proposed requirements are guided by what was required in the UK and NZ functional separation regimes.

Specific examples that the CCC believes should be legislated include;

- "Equivalence" should be defined to mean that Telstra cannot supply access seekers on terms and conditions less favorable than it supplies Telstra retail businesses
- Telstra's wholesale business should have discrete branding and identity
- Management and personnel should be strictly separated and remuneration tied to business unit performance, not group performance
- There should be strict information barriers and TLS retail and wholesale customers should interact with TLS wholesale using the same information systems
- There should be separate financial accounting between wholesale and retail businesses

These arrangements are the minimum required to effectively deal with the incentive to discriminate.

Ministerial Determination Details and Process

The success of the functional separation regime will rest entirely on the adequacy of the details of the Ministerial Determination and the extent to which they effectively translate the principles proposed by the Government in the legislation (assuming the principles are expanded as per the above).
The CCC therefore submits that it is important that the Ministerial determination is examined by those whose interests it is intended to advance – competitors who will rely on these rules to ensure they can compete on a level playing field.

The CCC proposes therefore that there should be a short period of consultation on the Ministerial determinations before they are finalised. A period of 14 days should be adequate, and this should be contained within the 90 day period for the development of the determination. This is important so that the overall deadline for the implementation of functional separation is not affected.

Some of the important questions that access seekers would be looking to understand and comment on are fundamental to their on going businesses. These include an explanation and invitation to comment on: What services are to be included in functional separation as regulated services? What, if any, declared services are not included and why? What services in addition to the declared services are included (such as wholesale ADSL or bitstream)?

Structural Separation

Transitional Arrangements

The legislation anticipates that Telstra might prefer to structural separate voluntarily and that, if it were to do this, functional separation would be unnecessary. The CCC believes this is appropriate.

Further, the legislation presents a process whereby Telstra can proceed to structurally separate voluntarily that is consistent with the intended outcomes in terms of a more competitive market from the functional separation initiative. Again, the CCC believes that this is the correct and responsible approach.

The legislation also seeks to anticipate how Telstra might proceed to a voluntary separation, proposing that it might;

- create a new, separate wholesale company, into which it sell its wholesale business to an existing company or
- transfer its assets over time to an emerging company.

The CCC believes that it is sensible for the legislation to consider how Telstra might structurally separate in order to ensure that the regulatory process both allows for this activity and is able to protect the policy outcomes through this process.

The CCC submits that the second option proposed – a separation over time – presents some greater challenges and questions. The timetable for the *completion* of structural separation by 2018 relates to the anticipated completion of the building of the National Broadband Network. While this date makes sense in this context, it is clear that it is not the Government's intention that the urgent and fundamental structural reforms to the industry are to be delayed until that time. The CCC strongly submits that reform must occur immediately and not be deferred to 2018.

Specifically, it is very important that the legislation places beyond doubt that Telstra will be required to *immediately* begin to implement changes in the way it manages its wholesale business in ways that remove the incentive to discriminate against other retailers, notwithstanding that the structural separation process may take some years.

The CCC submits that the legislation should be amended to make this requirement clear, and that the guidance to the ACCC in what it must consider in relation to a structural separation undertaking should include this requirement.

Ideally, functional separation should be implemented in full, as envisaged by the legislation, during the period that the staged structural separation is under way. This would allow competition to begin to grow. It should also not be a too great an imposition on Telstra itself, as it should be expected to be engaged in transforming its own internal business systems quickly in order to implement structural separation and position its retail business for longer term growth in a separated market.

However, the CCC acknowledges that of a functional separation regime designed to operate in perpetuity might include elements not be appropriate in a transition regime – perhaps because they would be duplicated other systems being put in place to implement structural separation.

For example, there might be some duplication of the information systems being developed for structural separation and functional separation. It might not be reasonable to require these elements in a transitional functional regime, if incentive changes can be effective without them due to the structural separation elements that could be fast-tracked instead.

One possible method of dealing with this problem would be for the addition to the legislation of guidance to the ACCC. The ACCC will be required to consider any voluntary separation undertaking developed by Telstra, including an undertaking for a staged structural separation undertaking.

The CCC suggests that the ACCC be given guidance that any undertakings show how the management of Telstra's wholesale business will be organized to remove incentives to discriminate during the period of a staged separation, and to that the guidance detail certain minimum requirements.

This would include, at a minimum – arm's length contracting between Telstra's wholesale and retail businesses; that Telstra's retail business can only acquire the same wholesale services available to competitors; that the wholesale and retail businesses report separate accounts, and; that the remuneration and incentives of the management of the wholesale and retail businesses are linked to the performances of those separate business units.

Unless the incentives to discriminate are removed during this transition, the potential and opportunities for anti-competitive action are unacceptably high.

For example, if Telstra reached an agreement with NBNco to transition its traffic onto the NBN as it was built, there would need to be assurances of equality of treatment for all customers transitioning from the copper network to the NBN, whoever they used as their ISP.

It would be too easy for Telstra and the NBNco to create favorable transition arrangements for Telstra retail customers, such as by transferring Telstra retail services in a shorter time than customers of other retailers when their services are disconnected from copper and put on to the NBN.

These types of inequities are common at present. Customers trying to move off Telstra services to other retail providers or trying to upgrade services often find that their service is disconnected for longer periods than the period during which Telstra Retail customers making similar changes are offline.

Structural Separation Process Transparency

The process whereby the ACCC considers any structural separation proposal from Telstra must be open to the highest level of public consultation. ACCC undertaking processes include public exposure of and consultation on the undertakings themselves, and draft decisions and consultations on draft decisions. Ex ante undertakings processes require similar public consultation.

From 2005 to 2007, Telstra and another group of prospective investors called the G9 held discussions with the ACCC with a view to presenting undertakings to build fibre to the node networks. The G9, later renamed Terria, submitted an undertaking which proceeded to the draft decision stage.

There was public concern expressed in both cases that there was too much private discussion between the ACCC and the parties proposing to submit the undertakings. Telstra accused the ACCC of acting as an advocate of Terria. The CCC and others expressed concerns that the public reports that the ACCC and Telstra were 98 percent of the way to agreement suggested that the Commission had gone beyond giving guidance about what was required for an undertaking to be accepted for consideration.

It is crucial that the highest standards of independence and open-mindedness are maintained by the Commission if it was presented with an undertaking for structural separation. The best way to ensure that this is the case is for the process to be open and transparent. This should be made clear in the guidance to the Commission.

Regulatory Changes

Variations Between Access Determinations and Access Agreements

The Government has recognized in its legislative package that the so called negotiate/arbitrate principle has failed. Negotiate/arbitrate is the idea that has underpinned the role of the ACCC in telecommunications since 1997. It is, in short, a requirement that access seekers attempt to negotiate a price with Telstra for access to a regulated service (such as wholesale line rental or call interconnection). Only if agreement cannot be reached, can the ACCC be asked to arbitrate between the parties.

The experience of the industry has been that this approach has been a dismal failure. Telstra has no incentive to negotiate a realistic price of access. Rather, it benefits from delaying the finalisation of a price for a service for as long as possible.

CCC members have waited seven years and more for price certainty on certain key access services. Telstra in the meantime operates freely in the retail market. These are not the circumstances under which businesses can be expected to invest and compete against a powerful incumbent.

The legislation discards this failed philosophy by requiring the ACCC to determine access prices and conditions, as it done in other network wholesale markets such as electricity and gas.

However, the legislation also attempts to retain a flexibility that the CCC is concerned may have unintended negative consequences.

One example of this is that the legislation allows for access agreements, where access seekers and access providers negotiate their own terms. The legislation anticipates that these private agreements might not be wholly consistent with access determinations by the ACCC. In these situations, the legislation allows for the access agreement to apply.

The CCC is concerned that this could encourage gaming. At its highest, this could render ineffective the price determination power being conferred on the ACCC, and create no improvement in the environment for competitors.

Regulatory processes toward setting indicative prices today are intended to guide private negotiations. However, these processes can often take longer than anticipated, and access seekers are forced to agree to contractual terms that are unfavorable simply in order to be able to be sure that a basic input service will continue to be supplied, and that they will be able to in turn guarantee supply to their own retail customers.

Access seekers signing agreements under duress in these circumstances rely on the ability to seek to have the arrangement superseded once the regulatory process is concluded.

Attempts in the legislation to provide flexibility would invite Telstra to seek to delay regulatory processes so that they are a mismatch with the timing of the expiry of commercial supply contracts. Then, Telstra would have an incentive to lock access seekers into higher prices. Any price determinations made later by the ACCC would be irrelevant.

In effect, the CCC submits that this provision is the last vestiges of the failed negotiate/arbitrate thinking and should be changed.

This aspect of the legislation is the single most concerning to CCC members because of the potential it raises for manipulation and gaming, which would give rise to great conflict in the industry. The CCC submits that the provision should be changed so that access seekers with commercial agreements, should be able to, on application to the ACCC, revert to the price and conditions determined by the ACCC.

One alternative would be some arrangement that ensured that access determinations were always concluded ahead of contract negotiations. However, this would not appear to be practical. The term of individual contracts can vary according to the needs of access seekers in downstream retail markets or by virtue of Telstra insisting on terms. Access seekers have little negotiating power because of Telstra's position as the sole source of supply, which is why the regulation of its conduct in these markets is required in the first place.

The CCC proposes that the preferable approach would be to amend proposed sections 152AY and 152BCC to state that access agreements only prevail over access determinations to the extent of any inconsistency where the inconsistency is for the benefit of the access seeker. Alternatively, if an access seeker is party to an access agreement and an access determination is made which is more favourable, the access seeker should have the right to terminate the access agreement and take the determined price.

"Discounts" From Determined Access Prices

Another example of an area where the Government is seeking to build in flexibility is the provision that access providers and access seekers can agree to prices below that determined by the ACCC. These agreements would need to be registered with the ACCC.

The CCC supports an arrangement whereby access seekers have the ability to negotiate a price below the price determined by the ACCC. However, the CCC is concerned that the provision as it present read creates an opportunity for unintended outcomes.

Specifically, it creates an opportunity for the access provider to engineer downstream competitive conditions such that one retailer is in a favorable position over another, perhaps for a reason strategically advantageous to the access provider. This is because there appears to be no constraint on the provision of purely subjective discounts to a “chosen few” retailers by the owner of the monopoly network.

Allowing subjective discounting creates an opportunity for discrimination for strategic reasons that might be detrimental to competition. For example, volumes might not result in any cost saving to the network owner, but might be desirable if the network owner wants to convince the retailer to move its traffic quickly from the legacy copper onto a new network. However, a retailer being afforded such a volume discount would become even further entrenched in the retail market if it enjoys a lower access price than all its competitors.

The CCC submits that discounts from the determined rate should be related to a demonstrable saving in supplying that service to a particular access seeker. For example, there might be some economy of scale related simply to the volume of a service supplied. However, volumes related cost savings should not simply be assumed, as changes in technology mean volumes do not necessarily result in lower costs of supply.

Equally, an access seeker with a small volume might invest heavily in its own infrastructure and in so doing place itself in a position where the network owner’s costs of supply are reduced.

The CCC submits that requiring the access provider and the access seeker to demonstrate savings that justify prices below the determined rates would encourage greater investment and competitive differentiation and allow for greater competitive entry, while reducing the opportunity for anti-competitive price discrimination.

Conclusion

The CCC has identified the above issues are areas in which the present legislation could be improved. Other minor changes might be identified on further examination of the Bill, and the CCC will present these in supplementary submissions if this occurs.

The CCC would also be happy to make representatives available to appear if requested.

However, the CCC again urges the Senate to support the legislation.