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Submission to the Senate Standing Committee on Environment, Communications and the Arts Inquiry into

Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009

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Summary: unnecessary regulatory risk and potentially sovereign risk

BT Investment Management Limited (BTIM) is one of the largest investment managers in Australia. BTIM is listed on the Australian Stock Exchange (ASX code: BTT) and manages over A$32.2 billion (30 June 2009) for investors. BTIM is majority owned by the Westpac Group.

BTIM has significant investments in the telecommunications and media sectors and holds one of the largest shareholdings in Telstra as well as shareholdings among a range of other Australian telecommunications companies.

We participated in the Australian Government's sale of Telstra shares in 2006 (T3) and paid what we considered was a fair price on the basis that, among other things, Telstra was an integrated company. Telstra management pursued strategies that allowed it to exploit the synergies from being an integrated company including its 'one factory model' and 'market based management'.

We also made the investment in the face of significant regulatory debate in 2006 around access prices and what appeared at the time to be one of the lowest access charges for unconditioned local loop (ULL). However, we accepted this and made our investment decision because we understood that access regulation was well established and necessary for effective competition but also that there was a well established process for setting access terms and conditions.

We consider that the Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2009 (the Bill) goes beyond well established regulatory practice and undermines independent regulation of the telecommunications sector by the Australian Competition and Consumer Commission. Our concerns are that the proposed legislation creates additional and unnecessary regulatory risk and so complicates risk assessment for investment purposes and potentially raises sovereign risk for our Telstra share holding.

In summary we have five specific comments:

1. The proposed legislation undermines independent regulation of and investment in the telecommunications sector because its intention is to coerce Telstra into agreeing to transfer customers to the proposed National Broadband Network or structurally separate rather than to effectively regulate bottlenecks in the sector. Parliament has previously passed legislation to sell Telstra as an integrated entity, and we relied on this legislation when we participated in the sale.

2. Restricting Telstra's access to certain 4G spectrum is counter-productive to effective industry development. It punishes Telstra's success in the mobile sector where it faces two well-established rivals. Telstra has built one of the great Australian businesses from the ground up and in particular through managing an insightful break-through investment in NextG four years ago. The company has spent billions of dollars on infrastructure, product development and marketing to reach its current position in the mobile market. Preventing the company from acquiring further spectrum would constrain the efficient future development of the business. This sends a poor signal to investors that support such investment.

3. We consider the ACCC has gone beyond the role of an independent regulator to be an advocate for the National Broadband Network (NBN) and the structural separation of Telstra. Neither of these are matters for an independent regulator. We consider the changes to access pricing and competition notices proposed in the Bill are unreasonable and give a role to the ACCC beyond what is reasonable for an independent regulator.

4. We consider the Government has relied on a distorted view of Telstra's dominance in the residential fixed line market, a view reflected in the Bill that undermines its effectiveness. Telstra's fixed line access business is a regulated business because it is an effective bottleneck. It's a circular argument to suggest that because Telstra owns the only regulated bottleneck asset that it makes the bulk of fixed line market profit and should be broken up. Whoever owns it will make such a regulated profit. In our assessment the regulated pool of profits has been in decline for years as access prices have fallen and as traffic has migrated to competitive platforms. In any case, assessments of profit share need to be considered relative to investment levels. We consider that Telstra's profit is high because it is a well run integrated business and because of its high level of investment relative to its competitors.

5. We consider structural separation to be a poor policy option. It adds little to competition in the fixed line sector. It adds considerable cost to Telstra and so destroys value for shareholders. We believe the Government has proposed it because it improves the commercial prospects for the NBN, and because it is popular with Telstra's competitors. We believe the proposal to withhold spectrum unless Telstra 'volunteers' to implement structural separation is intended to reduce the amount of compensation that may be paid in any arrangement with the Government's proposed NBN. We believe the Government has not made a public policy case for structural separation. We consider this should be a matter for a body such as the Productivity Commission to assess rather than the ACCC. In any case, whether there is a public policy case or not, if the Government intends to pursue structural separation it should pay full compensation having sold Telstra as an integrated company three years ago. As a significant Telstra shareholder we consider the matter of 'just terms' to be an important underlying right.

The proposed legislation undermines independent regulation of and investment in the telecommunications sector

Many aspects of the Bill demonstrate poor policy that will promote neither competition nor the broader long-term interests of end users. Some aspects of the Bill would conflict with Australia's international obligations. The draft legislation does not meet the objectives that the government set for the NBN.

We consider that the Bill is intended to improve the negotiating position of the NBN Company by coercing Telstra into migrating its fixed line traffic to the NBN. This is an extraordinary use of the legislative process more so as commercial negotiation is at a relatively early stage.

We believe while such negotiations take place, the legislation should be withdrawn and a more considered policy that meets the government's aims and obligations should be developed.

When the Government established the evaluation criteria for NBN Mark I (fibre to the node) it said the key criterion was "value for money." We wonder whether this is still the case for NBN Mark II given the Government has declined to undertake a cost benefit analysis? We raise this point because we consider that Telstra shareholders are being obliged to carry some of the cost of NBN mark II.

However, the Government's evaluation criterion which is of particular interest in the context of the Bill is the third which examines "*the nature, scope and impact of any legislative and/or regulatory changes that are necessary to facilitate the Proposal*". Our understanding is that the Government's intention was to minimise legislative props to the NBN, as explained in the Request for proposals (RFP) for NBN Mark I.

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"Proponents should note that, to the extent that legislative and/or regulatory changes are required in relation to the development and operation of the NBN, these changes will be limited to those necessary to directly facilitate investment in the NBN, and will not jeopardise the Commonwealth's other objectives including open access to the NBN and the achievement of interception, security and emergency call service objectives. Legislative and regulatory changes should also be consistent with Australia's international obligations." [Clause 1.5.39 of the RFP, April 2008]

A key objective of Part XIC (telecommunications access regime) of the Trade Practices Act (TPA) is to promote the long term interests of end users (LTIE). Determination of this objective requires achievement of the following sub-objectives:

- promoting competition in carriage services;
- achieving any-to-any connectivity across carriage services;
- encouraging the economically efficient use of and investment in infrastructure; which must have regard to (among other things) the legitimate commercial interests of the supplier (including scale and scope), investment incentives, (where relevant matters are not limited), and risks involved in making investment.

Coerced separation conflicts with this last objective in our view. It distorts investment in infrastructure and, as a specialist investment manager, we argue it undermines investment incentives by creating risk and uncertainty. It disregards the important investment issue of economies of scope and scale.

When it recently considered the merger of Vodafone and Hutchison, the ACCC "undertook an extensive investigation over 3 months." When it decided not to oppose this merger proposal the ACCC said it had regard for the need for mobile operators "to have sufficient scale to be able to continue to make significant investments in their network capabilities," (ACCC Media release, 29 May 2009).

Given the potential consequences surely a coerced de-merger proposal such that contained within the Bill should have no less extensive investigation? If Parliament is to consider any coerced separation we argue this should be on the basis of an extensive investigation. We consider the Productivity Commission is better placed to consider this than the ACCC.

We consider some aspects of the Bill would conflict with Australia's international obligations. The importance of these obligations were noted in the RFP for NBN Mark I. *"Proponents should note that Australia has multilateral international trade commitments under the World Trade Organization General Agreement on Trade in Services as well as bilateral commitments under free trade agreements such as the United States – Australia Free Trade Agreement and the Singapore – Australia Free Trade Agreement*." [Section 1.5.27 of the RFP April 2008]

Could the Government coerce SingTel or AAPT to "volunteer" to migrate traffic to the NBN by proposing a structural alternative, effectively undermining their bargaining position? As Telstra shareholders we wonder whether the company would be better treated by legislation if it re-domiciled in the USA (as News Corp did recently. To be clear we are not proposing that it do, simply asking for comparable treatment.

If Telstra were a US listed company we believe the Bill would create issues with the USFTA. For example: *Article 12.20 : Each Party shall administer procedures for the allocation and use of scarce telecommunications resources, including frequencies, numbers and rights of way, in an objective, timely, transparent and non-discriminatory manner.*

Also *Article 12.15: Neither Party may prevent suppliers of public telecommunications services or suppliers of value added services from choosing the technologies they wish to* *use to supply their services, including packet-based services and commercial mobile wireless services, subject to requirements necessary to satisfy legitimate public policy interests.*

Restricting Telstra's access to certain 4G spectrum is counter-productive to effective industry development and sends a bad signal to investors who support such investment

"The Government is proposing that Telstra will not be able to acquire spectrum for advanced wireless broadband while it remains vertically integrated, maintains its interest in Foxtel and owns a hybrid fibre coaxial cable network." [The Bill's Explanatory Memorandum, p39]

We consider that this proposal is diametrically opposed to the LTIE and in particular to promoting investment. As Telstra is a well-established mobile player with the customer base and resources necessary for 4G network and product development, withholding spectrum from it is counter-productive to effective development of the industry and works against the long term interests of end users.

What are investors to understand from such a proposal. That successful business development will result in a long term penalty?

Telstra's innovation and investment in mobile was seen as a high risk venture in 2006 and yet the success is best described by the list of international accolades:

- 2008 Best Mobile Carrier at Telecoms Asia awards
- 2007 IEC Infovision award for wireless broadband
- 2007 Internet technology of the Year award for wireless broadband
- 2007 Communications Alliance Innovation Mobility Award

Mobile is one of the few parts of the telecommunications market that is acknowledged to be highly competitive. The ACCC gives some of the credit for this to Telstra's large investment in its new mobile network:

"In 2007-08, there were signs of 'patchy' competition in fixed line services – as competition continued to develop at different rates in different geographic areas – while more extensive competition was evident in mobile services, with Telstra's investment in 3G networks in recent years driving much of this development" [ACCC, Division 11 Report for 2007-08]

Senator Conroy also praised Telstra's innovation:*"I want to congratulate Telstra for investing extensively in its Next G™ network which is cutting edge new technology. I appreciate the resources and commitment Telstra has brought to implementing its new national network,"* [Press release 18 January 2008]

Even the Explanatory Memorandum itself acknowledges this: "*The availability of spectrum has been essential in encouraging competition between different technologies, as well as different service providers of mobile services*. [p. 40]

The Explanatory Memorandum's analysis of the consequences for competition of the proposed exclusion of Telstra demonstrates wishful thinking in our view: *"If Telstra chooses to remain vertically-integrated, and is therefore unable to participate in the spectrum auctions it will open up the market to new entrants which would provide even greater competition in the mobile market …"* [p. 43]

There is not much chance of that. The competition limits power (i.e. under sections 60 and 106 of the Radio Communications Act) was introduced in 1997 to help establish new mobile entrants. At that stage, Australia already had three established mobile operators (Telstra, Optus and Vodafone) and since then a later entrant OneTel has gone into receivership and Hutchison, also a later entrant, has merged with Vodafone.

As we noted above when it recently considered the merger of Vodafone and Hutchison, the ACCC had regard to the changing nature of the mobile telecommunications industry and the increasing need for mobile network operators to have sufficient scale to be able to continue to make significant investments in their network capabilities.

In reaching its decision the ACCC considered evidence which showed that absent the merger, the parties are unlikely to sustain the significant investment in their mobile networks to provide competitive high speed data services, such as mobile broadband.

"Ongoing investments are needed to meet the increased customer demand for bandwidth-hungry data services, including mobile broadband. In this respect, the ACCC considers that mobile voice and data services will continue to converge in the future," ACCC Chairman, Mr Graeme Samuel said.

If the ACCC argue this in the case of the merger of Vodafone and Hutchison, on what basis can the Government argue that denying Telstra's participation in the spectrum auctions "will open up the market to new entrants which would provider even greater competition in the mobile market."

"Similarly, if Telstra decides to participate in the spectrum auctions a competitive market will also develop with the possibility of infrastructure-based competition to occur between the fixed-line telecommunication and the new cable network owner. The divestment of Foxtel would improve the environment for a competitive market to develop." [Explanatory Memorandump43]

The threat of exclusion relies on powers which should have been given up years ago. Under sections 60 and 106 of the Radio Communications Act, the Government can impose competition limits. A Productivity Commission 'Radiocommunications' Inquiry Report in 2002 recommended that these should be removed as "*unnecessary, potentially distortionary and procedurally deficient".* However, the proposal was rejected by the Government in December 2002.

At the ACCC Regulatory Conference earlier this year, a key speaker noted that "*Rules that impede competitive rivalry or delay the productive use of spectrum are highly likely to flunk the cost-benefit test"* [US Wireless Auctions 1994-2009, presented to the ACCC Regulatory Conference, July 2009 by Professor Tom Hazlett). In question time, Professor Hazlett was asked if the 'rumour' that Telstra might be excluded from a future spectrum auction would be bad public policy. Being polite to his hosts, Professor Hazlett was constrained in our view to say that such policy would be "problematic".

Hutchison also argued recently against competition limits:*Hutchison also does not consider competition limits appropriate on spectrum unless the Government identifies clear quantifiable net social benefit from restricting competition for newly available spectrum.* [National Broadband Network Regulatory Reform for 21st Century Broadband—Submission by Hutchison 3G Australia Pty Ltd, 3 June 2009, pp.4–5]

A cost-benefit test for such a proposal is certainly appropriate. Under the Competition Principles Agreement, the Commonwealth and all State and Territory governments agreed to the 'guiding principle' that legislation should not restrict competition unless it can be demonstrated that the benefits of the restriction to the community as a whole outweigh the costs, and the objectives of the legislation can only be achieved by restricting competition. Parties are required to review all legislation against this principle.

The Explanatory Memorandum to the proposed legislation says lamely in our view that: *"There could be a cost to the Commonwealth Government if Telstra chose not to participate in spectrum auctions due to the loss in competitive tension. However the Government considers the benefit of a more competitive telecommunications sector outweighs the potential loss of revenue from spectrum auctions."* [p. 42]

This is not good enough for public policy purposes in our view. Restricting competition has real costs for end-users that need to be calibrated. Indeed, it is obvious to us, that the only reason for proposing to exclude Telstra from spectrum auctions is to coerce it to structurally separate:

"If the Minister is satisfied that a structural separation undertaking given by Telstra is sufficient to address concerns about the degree of Telstra's power in telecommunications markets, the Minister may remove either or both of the requirements for Telstra to divest its hybrid fibre coaxial cable network and divest its interests in Foxtel." [Explanatory Memorandump93]

We consider that it is a stick the Government has got to beat Telstra into submission for an NBN agreement that works for the Government. We think this is bad public policy. Where the Government needs Telstra's support to make the NBN viable, it should bargain for it on its merits and pay appropriate compensation.

We consider the ACCC has gone beyond the role of an independent regulator and that the changes to access pricing and competition notices are unreasonable

Competition Notices

"*This Bill will remove the requirement for the ACCC to undertake consultation before issuing a Part A competition notice. This Bill also explicitly provides that the ACCC is not required to observe any requirements of procedural fairness in relation to the issue of a Part A competition notice*…(However*) If the ACCC commences court proceedings to enforce a Part A competition notice, the ACCC would still have to prove to the court that the competition rule had been breached by the alleged offender ".*[Explanatory Memorandum, p. 6]

Part IV of the TPA regulates anti-competitive behavior. Additionally, the telecommunications sector alone is regulated by Part XIB which is similar to Part IV. There are two key differences:

- First, under Part XIB carriers and services providers are prohibited from taking advantage of market power with the <u>effect</u> of substantially lessening competition; which is more likely to lead to prosecution than the <u>purpose</u> test applied in Part IV.

- In addition, in order for proceedings to be instituted under Part XIB (by the ACCC or a third party), the ACCC must issue a 'competition notice'. In certain cases, a competition notice <u>reverses</u> the evidentiary burden in a court proceeding.

Two different types of competition notice can be issued by the ACCC when it has reason to believe that a carrier or CSP has engaged, or is engaging, in anti-competitive conduct.

- A Part A competition notice serves as a warning that the ACCC has competition concerns in relation to the conduct of a carrier or CSP and that further investigation of this conduct is required. A key consequence of such action is that it enables affected third parties to take their own damages actions in the Federal Court.

- A Part B competition notice can be issued when the ACCC has reason to believe that the carrier or CSP has committed, or is committing, a contravention of the competition rule. Once issued, a Part B competition notice reverses the onus of proof in relation to matters in the notice (i.e. it is prima facie evidence of the contravention if proceedings are subsequently brought under Part XIB).

The ACCC did not issue any competition notices in the 2007–08 financial year, the last year for which it has issued a competition report.

Section 151CN of the TPA 1974 required that a review of Part XIB be conducted by July 2000 as Parts XIB and XIC were intended to be aligned eventually with general trade practices law [H Gray, Evolution of infrastructure competition in Australia, ACCC Working Paper No. 1, July 2009]. The Productivity Commission was commissioned to do this review and its draft report suggested the repeal of Part XIB. But this was dropped in the final 746 page report given to the Minister in September 2001 on the strict proviso that an appeal mechanism be introduced even after the withdrawal of a competition notice:

"the competition notice regime, which reverses the onus of proof, coupled with provisions for penalty, deter a firm from going to court…The Commission believes that the effective absence of appeal adversely affects procedural fairness and is a serious flaw in current arrangements. As well, it might reduce the discipline on the ACCC to ensure rigorous analysis and encourage use of Part XIB where Part XIC or action under the Telecommunications Act might be more appropriate." [Productivity Commission, p192]

The Government rejected this recommendation in September 2001 choosing instead to allow the ACCC to issue an "advisory notice" advising a party of the action that it should take, or consider taking, to ensure that it does not engage, or continue to engage, in anti-competitive conduct.

"*This Bill will remove the requirement for the ACCC to undertake consultation before issuing a Part A competition notice. This Bill also explicitly provides that the ACCC is not required to observe any requirements of procedural fairness in relation to the issue of a Part A competition notice*." [Explanatory Memorandump6]

This proposal is diametrically opposed to the direction urged by the Productivity Commission. The removal of the requirement of procedural fairness puts the ACCC in a powerful and unchecked position. We consider it is unfair and open to abuse.

The reach of XIB is proposed to extend to content services these are defined in S15 of the Telecommunications Act which include "*a broadcasting service, online information service, online entertainment service, any other online service, or any other service as determined by the Minister"* [Explanatory Memorandump6] Clearly, the ACCC is shaping-up to get into pay TV issues and on line content issues which may well have implications beyond Telstra.

The ACCC already has wider discretionary powers over conduct in the telecommunications industry than apply in other industries. The two proposed changes listed above increase regulatory uncertainty which is not in the LTIE because it inhibits competition and increases risks in making investment.

Access

"Part XIC will be modified to remove the option to apply for exemptions from access obligations or undertakings, except in relation to new services which are deemed to require regulatory relief to stimulate innovation in the market. To promote regulatory certainty and timely decision-making, merits review of decisions under Part XIC will no longer be available. Judicial appeal processes will still be available, however, for parties wishing to appeal a point of law." [Explanatory Memorandump6]

The Bill proposes to remove merits review <u>entirely</u> from Part XIC which would leave the ACCC even less accountable. When the Productivity Commission issued its 2001 report into Telecommunications Competition and Regulation, merits review applied to individual exemptions (TPA s152AW), access undertakings (TPA s152CE and CF) and final determinations (TPA s152DO). Despite its recommendation to retain these, the 2002 legislation removed the merits review for final determinations because the Government considered the need to promote certainty and timeliness of access outweighed the risk of regulatory error.

As the Productivity Commission warned: *"At stake is infrastructure worth billions of dollars and the pricing of access services that the key to the nature of competition in Australian telecommunications. The matters are complex, basic methodologies have been questioned and continuing debates ensue over key parameters. There is unquestionably scope for regulatory error. Were there to be no review process, the care taken by the ACCC to set efficient terms and conditions could be reduced. Eliminating the scope for an appeal removes the possible divulgence of regulatory error, but it does not remove its consequences for the affected parties."*[Productivity Commission, 2001, p340]

Nothing has changed in our view and the stakes are higher.

Since it is clear that the 'negotiate-arbitrate' model is not producing effective outcomes for industry or consumers, Part 2 of Schedule 1 to the Bill reforms the regime to allow the regulator to set up-front prices and non-price terms for declared services" [Explanatory Memorandum, p6].

The ACCC notes that since 1997 it has been notified of *"well over 100 access disputes under Part XIC. In contrast, three access disputes have been received under Part IIIA of the Act since its introduction in 1995".* [ACCC Division 11 Report for 2007-08, p17]. But this is because the ACCC fixes arbitrations on a case by case basis. Unless an access seeker raises an access dispute, it does not get lower prices. And they have to keep going back or have other access-seekers leap-frog them with a better deal.

The Government notes that access disputes can cost access seekers hundreds of thousands of dollars per dispute, while Optus estimates that the overall cost to industry of regulatory proceedings over the last 12 years is at least $200 million [Explanatory Memorandum, p52]. But, the returns on these investments have cost Telstra a lot more than $200m.

Most access disputes say nothing about whether the LTIE has been well served. The ACCC does not have to justify its pricing in arbitrations. Because a merits review is only possible in relation to the ACCC's rejection (or acceptance) of an Undertaking, there is a powerful incentive to the ACCC not to accept an Undertaking and forgo the discretion to set prices in arbitration.

Currently, the ACCC must set "model terms and conditions" for all declared services. Under the proposed legislative changes it will be able to set the prices directly for three to five years. We can expect <u>no disputes</u> if the ACCC gets the new power to set *"up front prices for declared services"* and an access provider cannot argue with the ACCC. On this basis, Division 8 of Part XIC, which deals with the notification and arbitration of disputes, would be repealed [Explanatory Memorandum, p166].

As investors in Australian telecommunications we consider there are huge risks in allowing the ACCC to set prices up front without any right of appeal. Ordinarily in a market price setting is a right that follows investment, and in turn is instrumental in driving investment. The ACCC is not a market player; it does not make investment decisions and it does not face investment risk.

Having the ACCC set up front access prices undermines investment decision making. It places the ACCC in front of investment and effectively puts it in the role of a central planner, at the least the pricing component of central planning with follow on effects on investment. Any market player needs to support its actions (whether pricing or investment) in a market to ensure they have the desired effect. If the ACCC becomes an advocate for a particular investment or pricing of that investment, how can it then regulate independently of those decisions? Because it requires a "buy in" into key industry decisions an upfront pricing role undermines the ACCC's position as an independent regulator.

The Bill also proposes give the ACCC a monopoly of proposing prices. Telstra would no longer have the right to submit its own undertakings: *"Ordinary access undertakings will no longer be a part of the telecommunications access regime. Only special access undertakings will be available."*[Explanatory Memorandum, p160] The ACCC is going to develop its own undertaking and it will not be subject to appeal.

Special access undertakings will only be able to be lodged concerning services for which a section 152AL declaration is not in force (ie for new services).

It is in the LTIE to enable the proper functioning of markets. What is proposed is an unprecedented extension of the ACCC's power into setting prices undermining commercial processes. This is aggravated by reducing the protection against regulatory over-reach and regulatory error through removing all appeal processes.

We consider the Government has relied on a distorted view of Telstra's dominance in the residential fixed line market and that this is reflected in the Bill and undermines its effectiveness

We consider the Government has a distorted view of Telstra's dominance in the residential fixed line market by relying on selective information on market share, ignores rival investment as a competition factor and ignores recent market share and operational success by better managed competitors. It ignores the effectiveness of regulated access in achieving better competition. It ignores the more substantial ACCC advice that "(t)he emergence of competition has depended upon the regulatory mechanisms in the access regime and has been achieved incrementally as Telstra's competitors have built up customer bases and are now investing in and installing infrastructure of their own in more densely populated areas" [ACCC, Telecommunications Competitive Safeguards for 2007–2008].

The Explanatory Memorandum notes "the Australian telecommunications market is characterised by a very strong and highly integrated incumbent, Telstra. … partly because of this integration, it has been able to maintain a dominant position in virtually all aspects of the market, … It is the Government's view that Telstra's high level of integration has hindered the development of effective competition in the sector. [Explanatory Memorandum, p 3].

This may be the Government's view but it is not a view supported by the ACCC's latest competition report [ACCC, Telecommunications Competitive Safeguards for 2007–2008] which does not mention Telstra's degree of integration as a competition factor at all. The report mentions "structural features" as a competition factor but this applies to all carriers and market structure in general. We consider it applies in particular to the low level of fixed line investment by some but not all rival carriers.

In its summary of the current state of competition in the market the Explanatory Memorandum also notes only the views of the ACCC and quotes selective statistics from the ACCC [Explanatory Memorandum, p 22-23].

We consider these statistics do not provide a sufficiently good indication of the state of competition in the fixed line on which to base legislation that so substantially changes industry structure and so severely penalises one group of investors. Instead, we consider they create a distorted view of the residential fixed line market, including broadband and leads the Bill to propose measures which are unlikely to be effective in promoting competition but will impose costs on Telstra shareholders.

We consider that competitive carriers that have invested well and been active in market development have seen improvements in market share and operating performance (eg iiNet, Internode and TPG) while those carriers that have invested little or poorly and have relived more on regulation to replace market activity have been less successful in market share and operating performance (eg Optus, AAPT and Primus). This is a normal market outcome, albeit one supported by effective access regulation.

The poor fixed line market performance of Optus, AAPT and Primus including their market share are most directly a result of their investment and market activity in that sector. These companies have had low levels of fixed line investment for many years and have spent relatively limited amounts on fixed line retail marketing.

The 2008 data reported in the Explanatory Memorandum (p 23) are selective and distorted. It's clear that Telstra's market share of fixed broadband increased in the year to June 2008. However it is misleading and incorrect to attribute this to Telstra's high level of integration. Telstra's market share gains in 2008 are influenced by its rapid rollout of ADSL2+, a point acknowledged by the ACCC.

The 2009 data show a different story with strong market share gains to carriers that have been prepared to act competitively.

Australian retail fixed line broadband market (cable and DSL)

	Unit	Dec-06A	Jun-07A	Dec-07A	Jun-08A	Dec-08A	Jun-09A
Telstra retail	k	1,668	1,910	2,103	2,254	2,297	2,274
- Market share	%	44.6	42.3	46.1	46.7	45.1	44.6
Optus	k	705	810	867	890	904	936
- Market share	%	18.8	18.0	19.0	18.5	17.8	18.3
iiNet	k	314	332	350	373	400	421
- Market share	%	8.4	7.3	7.7	7.7	7.9	8.3
Primus	k	300	304	307	310	306	302
- Market share	%	8.0	6.7	6.7	6.4	6.0	5.9
AAPT	k	142	174	177	157	142	127
- Market share	%	3.8	3.9	3.9	3.3	2.8	2.5
Soul/TPG	k	171	188	130	281	327	384
- Market share	%	4.6	4.2	2.8	5.8	6.4	7.5
Other	k	442	794	629	557	713	658
- Market share	%	11.8	17.6	13.8	11.6	14.0	12.9
Total market	**k**	**3,742**	**4,512**	**4,563**	**4,823**	**5,089**	**5,102**

Note: Excludes wireless broadband. Jun-09 subscriber numbers for Telstra and Optus are reported; Soul (July YE) figures have been adjusted to reflect June YE.

Source: ABS Internet Activity Surveys, company data, RBS estimates

In contrast to Optus, AAPT and Primus; several carriers including iiNet, TPG and Internode have improved market share substantially and operating performance as a result of investment decisions made consistently over several periods and supported by good marketing and operations. They have boasted of this after their recent strong operating results:

- "We have been public about our intent to grow our market share of fixed broadband customers in Australia from the current level of 8% to around 15% as quickly as possible. ... We climbed from 6% at the end of the last financial year to 8% at 30 June 2009 (DSL only) through organic customer growth of iiNet and Westnet." (Source: iiNet Annual Report, p.16)

- “After five years of record growth, Internode has seen growth rates abate to more manageable levels as the Australian broadband market approaches saturation. … Our focus is on gaining market share he (CEO Patrick Tapper) said. We aim to make it as easy as possible for customers to get plenty of value out of their broadband service. … During the past year, we have signed wholesale ADSL2+ service agreements with both Optus and Telstra, which allow customers to choose Internode as their preferred broadband provider no matter where they live in Australia. At the same time, we continue to install our own DSLAM equipment in telephone exchanges so we can give customers the best possible broadband experience." (Source: Internode press release, 3 April 2009)

- 9.2% market share of DSL broadband at June 2009, or about 384k subscribers. Since June 08 TPG’s DSL subscriber base has grown 28%, whilst the total DSL market has grown 6% over the same period. (Source: SP Telemedia FY09 results presentation)

It’s clear that Telstra’s market share of fixed broadband increased in the year to June 2008. However it is misleading and incorrect to attribute this to Telstra’s high level of integration. “…(it) has been achieved incrementally as Telstra’s competitors have built up customer bases and are now investing in and installing infrastructure of their own in more densely populated areas” [ACCC, Telecommunications Competitive Safeguards for 2007–2008].

The Explanatory Memorandum cites the ACCC in support of the view that “the very high concentration levels are likely to be influenced heavily by Telstra’s level of vertical integration in the market” [Explanatory Memorandum, p22]. However, the ACCC report doesn’t say that at all. It does mention “structural features such as the number of sellers, their market shares, the service concentration levels and the barriers to entry and exit (such as the high sunk costs traditionally associated with communications services)” but in around 90 pages it does not mention vertical integration at all let alone as a cause of concentrated market share outcomes [ACCC, Telecommunications Competitive Safeguards for 2007–2008, p 27].

(Nor in a quick review of the ACCC’s competition reports for several previous years could we find that the ACCC specifically attributed high concentration levels to Telstra’s level of vertical integration.)

To support this piece of legislation the Government has ignored all of the other structural issues including rival investment and instead it has added the unsubstantiated claim about vertical integration. Given the consequences of the legislation and the valuation impact for Telstra shareholders and investors, we think this goes too far.

Telstra’s access network may be a bottleneck to the development of competition in many areas but the best way to deal with this is through access regulation. Where access is effectively regulated, competition has developed on the back of rival investment and good market operations. Access regulation is a better way to deal with this than separation given the significant costs caused by separation. We think the evidence on the causes of Telstra’s market position have been distorted to justify separation rather than being assessed on their merits.

We consider structural separation is a poor policy option. It adds little to competition in the fixed line sector. It adds considerable cost to Telstra and so destroys value for shareholders. We believe the Government has not made a public policy case for structural separation. We believe the Government has proposed it because it improves the commercial prospects for the NBN, and because it is popular with Telstra’s competitors.

"To ensure that competition across telecommunications platforms can prosper into the future, Telstra will be required to structurally separate, divest its cable network and Foxtel interests in order to acquire spectrum for advanced wireless broadband. However, under the legislation, the Minister has the power to exempt Telstra from requirements to divest its cable and pay-tv assets"[Explanatory Memorandum, p36]

There are two ways of interpreting the focus on separation. One is that the Government genuinely believes that the level playing field is more level when wholesale and retail operations are separated as this stops discrimination in favour of the owner's own retail operation. After all, NBN Co, has been set-up in just this manner and all access-seekers have been putting this case for some time.

However, the evidence on the efficacy of structural separation as a remedy for competition issues is assertive and lacks analytical rigour in our view. A recent Brookings Institution study argues that it is, "*unlikely that vertically-fragmented network owners and service providers would have as strong incentives to invest as would a vertically-integrated service provider...One of the key benefits of vertical-integration is the ability to share knowledge between the downstream and upstream divisions – for example, the upstream division is likely to have unique insight into the costs of constructing an NGN, while the downstream (retail) division is likely to have better information on the types of services consumers may demand from the network (and their willingness to pay)"* [R Leighton, R Crandall and J Eisenachs, Vertical Separation of Telecommunications Networks: Examples from 5 Countries, September 2009]

Also, a recent study drawing a parallel with the separation experience in electricity markets concludes that the benefits of structural separation are *"dwarfed by the sum of increased costs and dynamic efficiency losses from misaligned incentives"* [B. Howell, Cutting the ties that bind: Structural separation and investment incentives for fibre-optic broadband in NZ, August 2009]

If Telstra had not inadvertently dropped out of the NBN Mark I process, would the Government have still insisted on separation? It is true that it would not give Telstra assurances it sought, and this may be one reason it dropped out. But, if Telstra had been the last man standing to deliver NBN Mark I, wouldn't the Government have worked out some mutually acceptable level of separation to achieve its election promise?

"If the Minister is satisfied that a structural separation undertaking given by Telstra is sufficient to address concerns about the degree of Telstra's power in telecommunications markets, the Minister may remove either or both of the requirements for Telstra to divest its hybrid fibre coaxial cable network and divest its interests in Foxtel." [Explanatory Memorandum, p93]

A more likely interpretation of the emphasis on separation is this is a blatant attempt to coerce Telstra into supporting NBN Co., as discussed earlier.

With NBN Mark I, which was predominantly fibre-to-the-node (FTTN), regulators saw sub-duct access from the node to the premise as the key to continuing infrastructure based competition; and a close analogue to the unbundled local loop service (ULLS). With fibre to the premise (FTTP) in the current wholesale-only NBN Co context, this sub-loop access is no longer possible and parallel access networks are now definitely discouraged.

Since April 2009, we believe that the Government has become aware that it has merely exchanged one tractable compensation issue for another less tractable one. One reason for aborting NBN Mark I was that if Telstra were not the chosen agent, the Commonwealth was facing a $20 billion compensation issue in getting access to the copper sub-loop to make the FTTN. It thought it had neatly side-stepped this by dispensing with the sub-loop by going all the way with FTTP. But what that meant was that the FTTP would run parallel to the existing copper network where all the PSTN revenues would likely remain and access-

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seekers would continue to purchase unbundled local loop or line sharing services to provide retail broadband services more cheaply than NBN Co would be able offer with its higher cost structure.

With the exception of high density areas like the CBD, fixed broadband is a natural monopoly. The existing copper network and FTTP network cannot co-exist with one or both losing money. But persuading Telstra to migrate its retail and wholesale customers from its copper network to NBN Co.'s FTTP network requires some form of enticement or compensation – or nasty threats like depriving Telstra of access to spectrum and making its life very unpleasant.

How is it in the LTIE or promotion of competition to employ such stand-over tactics to prop-up a new monopoly? Why could not Telstra and NBN Co. have been left to negotiate a commercial outcome?

s577A requires that: *"Telstra, at all times after a specified day, ceasing to supply fixed-line carriage services to retail customers using a telecommunications network over which Telstra is in a position to exercise control. Additionally, Telstra must take all reasonable steps to ensure that a company over which Telstra is in a position to exercise control will not supply fixed-line carriage services to retail customers using such a telecommunications network."*[Explanatory Memorandum, p93]

The head of NBN Co., Mike Quigley, has said his focus is on "*where economies of scale mean one supplier is most effective …(and hence) outside major centres and outside inter-capital backhaul"* [NBN Co – Initial Steps, 23 September 2009] That is, there is viable competition between broadband networks in high density metro areas and NBN Co will not go there.

In CBD areas there are already competing optical fibre networks yet s577A of the proposed legislation appears to require only Telstra to divest itself of its CBD networks. How does that promote competition and the other tenets of the LTIE?

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