“What is Happening to Competition?”

Address to Australian Telecommunications Summit 2008

David Forman
Executive Director
CCC

I want today to put aside NBN arguments for a moment and talk about the environment in which the Government decision on the NBN will be made.

Specifically, what is happening to competition? And is it what we want as a country?

It is worth laying out first the background to the state of competition today.

The CCC and its members have argued for many years that the regulatory arrangements are and have always been inadequate to deliver competition as was intended when the Parliament introduced competition in telecoms.

Certainly, all the international evidence from independent sources such as the OECD over the years has painted a picture of a market that was falling behind the rest of the world across all measures of consumer benefit. The data has also confirmed that the leading countries in the world in terms of prices and product innovation are those that have the strongest competition.

Despite this, when the American management of Telstra arrived in 2005, we saw them immediate launch a relentless attack on the policy and regulatory regime to support competition in Australia.

We at the CCC argued at the time that there was nothing in the regime that could contain their conduct effectively enough to protect competition from being seriously weakened.

Our warnings were ignored. Policy makers and regulators seemed content to be seen to “hold the line” against some of the Telstra management’s more outrageous demands. But they did not acknowledge that the aggressive conduct of Telstra toward its wholesale competitors meant that commercial relationships in the industry had descended into trench warfare.

And the regulatory and policy arrangements would not be able to stop this strategy from Telstra from succeeding in damaging competition.

The material I will present to you today comes in the main from Telstra itself, and demonstrates that our warnings about the future of competition were well founded.

Let’s take a step back to 2005 and the first major presentation from Mr Trujillo to the Government. You might remember he was later forced to reveal this to the entire market because of allegations that he had breached his disclosure responsibilities. Again, remember this context, because it is important.

Mr Trujillo came to Canberra having just released a pessimistic annual report that saw the Telstra share price collapse, just when the Federal Government had declared its intention to sell the remaining public portion of Telstra shares.

Mr Trujillo presented the following table as a warning to the Government that if it did not act to support Telstra’s interests by weakening competition laws, and further by allowing it to build a broadband network on its own terms, T3 would be at risk.

Trujillo in 2005 discussing T3 value: The Plan to Stop Competition Revealed

Key: Total number of lines (M) | Number of lines lost (M)

	1997	1998	1999	2000	2001	2002	2003	2004	Cumulative % line loss (since peak)
European Telcos									
Deutsche Telekom	37.8	-1.4	-1.9	-2.6	-1.8	-1.5	-1.4	-1.0	-31%
Telecom Italia	24.8	-0.5	-0.8	-0.9	-0.6	-0.7	-0.7	-0.4	-19%
France Telecom	31.6	-0.4	-0.7	-0.7	-0.3	-0.3	-0.4	-0.3	-10%
Telefonica	15.0	15.7	16.0	16.2	-0.1	-0.6	-0.4	-0.2	-9%
US Telcos									
SBC			59.7	61.3	-0.6	-3.5	-2.4	-2.3	-14%
BellSouth			25.5	25.9	-0.2	-1.1	-0.9	-0.9	-12%
Verizon			62.0	62.4	62.5	-4.5	-2.4	-2.6	-15%
Qwest			17.8	18.1	18.2	-1.2	-0.8	-0.7	-15%
Telstra			10.1	10.4	10.5	-0.1	0.0	-0.1	-2%

The table showed that in the rest of the world, there was well under way a dramatic move away from plain old telephone services that had been the rivers of gold for incumbent former monopolists for a generation.

The table showed the decline in total incumbent lines across different countries from their peak. His point was that once customers began to move away from the incumbent and its legacy services, the number of lines "fell off a cliff" to use a Telstra term from the time.

Of course, there is another way of perceiving this. This is competition policy at work, succeeding. Once customers were given the choice of competitive services, they grabbed the opportunity with both hands. They move not just to competitors reselling the legacy services, but on to broadband-based voice services, competitive mobile voice services and in some cases to cable-based services.

They moved away from the old monopolists because they were offered a better deal. The same thing happened in one market after another.

The key feature of this chart the Mr Trujillo pointed to was that this transition from the communications services of the 20th century to the next generation had barely begun to affect Telstra.

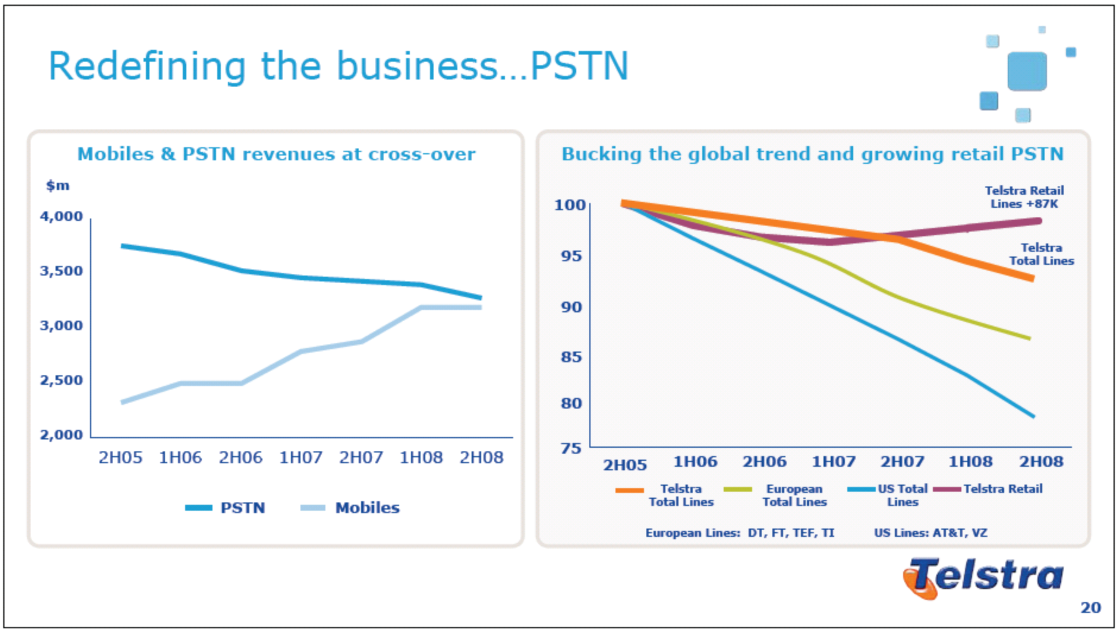
He presented it to call for the Government to act to continue to protect Telstra's revenue and profits to make sure T3 was a success.

But it is actually compelling proof that Telstra had been sheltered from competition in ways its overseas counterparts could only dream of.

Nevertheless, Mr Trujillo identified this as the big issue for his management and set about a war on regulation to protect Telstra from the impact of competition.

In Telstra's annual report this month, he presented the following slide, the highlight of which is the right hand table headed "bucking the global trend and growing retail PSTN".

From Telstra 2008 annual report: The Plan Delivered



Yes, this is Mr Trujillo's "mission accomplished" declaration. It is a boast that since 2005 he has turned back the tide of competition. Australia has, uniquely in the world, moved back toward 20th century services supplied by the old monopolist, while the rest of the world has continued to move on.

This graph might be a triumph for Telstra but it is truly a national embarrassment. We are now up to 10 years behind the rest of the world from the point when the competition starting gun was fired.

How can this have happened? We know that Telstra charges the highest prices in the developed world according to the independent analysis of the OECD and others. We know it has been among the slowest in the world to release new services such as ADSL.

It should be ripe for competitive attack from the new services that competitors in other countries have brought to customers.

How is it possible that competition is in retreat?

Other material in the Telstra report supports the contention that competition is, indeed, going backwards.

There are the obvious numbers – Telstra's profit is up, its revenue is up, its market share is up. All of these should be going in the opposite direction if competition policy was working.

But there is more granular data that provides some of the explanation for how this is happening.

While Telstra has increased the number of retail phone lines, wholesale phone lines – that is, those customer lines turned over to competitors – dropped by almost half a million.

This could be a good sign. It could be that this is competitors who – like all the fixed line carrier members of the CCC – have invested in their own equipment in Telstra exchanges are now moving off customers off wholesale and on to the unbundled local loop.

That is, rather than reselling a Telstra wholesale service, they are unplugging customers' copper lines from Telstra and plugging them into their own equipment, renting only that piece of copper from Telstra.

However, again from Telstra's own report, we can see that only 234,000 customers moved to that service.

Behind the Numbers: What is Happening to Wholesale End Users?

	2007	2008	change
Total ULLS	293,000	527,000	234,000
Wholesale lines	1,980,000	1,500,000	(480,000)

246,000 SIO's lost to wholesale? Is this what competition is supposed to be doing?

So, about a quarter of a million Australians that were connected to competitors in 2007 are no longer connected to them.

Some may be cut off altogether, but Telstra boasted that it has increased its retail lines at the same time. So at least many tens of thousands have gone from competitors to Telstra, completely contrary to what competition policy in telco supposed would happen.

What is going on?

Maybe it is just a retail market phenomenon.

Maybe Telstra is just offering great deals, too good for customers to refuse?

Or maybe competitors in Australia, uniquely in the history of micro-economic conduct, are just so lazy that they are not trying to compete or are pricing higher than Telstra by choice?

Let's look first at the first proposition. That Telstra is offering great deals suddenly.

In fact, Telstra says that its average revenue per user for ADSL is **up** in the year by 6.9%.

Again, let's look at this in the international context to get some perspective on it.

Ofcom, the regulator in the UK, released a major report called the Communications Market Report in the past few weeks. It says "During 2007 the estimated average cost of a residential broadband connection fell by 8%".

What is Happening to Broadband Prices as Competition Declines? UK vs Australia

From Ofcom Communications Market Report August 2008

"During 2007 the estimated average cost of a residential broadband connection fell by 8% to £14.11 a month, while the average cost of an SME broadband connection fell by 12%, to £18.04 a month (both excluding VAT)."

From Telstra Annual Report 2008

- ADSL Average Revenue Per User **up** 6.9%

Again, from the point of view of the actual Australian customer compared to what the citizens of other countries are experiencing, we would seem to be going in the wrong direction.

So it's not that Telstra is suddenly offering spectacularly price reductions or services any better than competitors. They were the last broadband ISP to offer ADSL2+ after all.

So, maybe competitors are just being lazy and letting Telstra get away with this?

Well, let's look more closely at those wholesale lines that we saw earlier were falling in number.

This is a table constructed from Telstra annual reports over the past four years. It takes the revenue Telstra reports from retail and wholesale lines, and divides it by the number of retail wholesale and retail lines in that year. The result is how much Telstra is paid per year per line by customers, according to its own accounts.

In 2005, the figures were not startling. Wholesale line revenues were a little under 10% below the retail line revenue on average.

But ever since then, wholesale revenues have been above retail revenues. And the gap widens every year.

This raises an immediate flag? How can something cost more wholesale than retail? Isn't that evidence of a broken market? And how can it be a whooping $68.50 more a year, or about 20% more?!

These Telstra figures show that Telstra has been driving up prices for competitors so much that it is now able to start increasing its own retail prices again. And the regulatory rules are so weak, or so weakly enforced, that it has been getting away with it.

How is This Happening?

Telstra Per Revenues recovered from all Wholesale Lines and all Retail Lines
From Telstra Annual Reports 2005-2008.

Year	Wholesale	Retail	Difference
2005	$307	$338	($31)
2006	$336	$333	$3
2007	$377	$332.50	$44.50
2008	$407	$339	$68.50

Telstra last year recovered $407.33 per wholesale line for basic access, and only 338.81 per retail basic access line.
Wholesale revenue is now **$68.52 above** retail.[i]

What is going on as a consequence of this in the world inhabited by real Australian customers is that competitors are simply no longer selling service in some places.

You wouldn't know this from the lack of urgency in the reports from policy makers or from the suite of reports from consultants paid by Telstra to tell us how tough and unfair life is for Telstra.

But you would know it if you are one of the thousands of Australians who live in areas where Telstra has been systematically tightening its grip in the past three years.

Competitors have had to accept that is not worth their while trying to compete with Telstra when Telstra's wholesale prices have risen so far above retail prices.

This should be no surprise to regulators and policy makers – Optus for one has said it will only sell services to customers it can reach from exchanges where it has its own equipment.

Further, as we all know, many customers connected even to those exchanges have requests for connections from competitors rejected by Telstra.

Telstra rejects the requests for various reasons – because of distance from exchanges, line quality or other faults in the copper, some of which Telstra has deliberately installed over the years.

And my members report that those rejections are on the increase, not declining.

That means many Australian telecommunications consumers today have **less choice than they did three years ago**.

Is it any wonder that we are sliding backwards in international comparison tables while Telstra is climbing up the profitability charts?

What Does this Mean?

The new Telstra management quickly saw the ineffectiveness of the regulatory regime three years ago and has ruthlessly exploited it. The ACCC has been unable or unwilling to prevent it. Policy makers have not responded.

The damage is accelerating and cannot be entirely reversed. The people suffering the damage are Australian consumers. Prices are high and appear to be getting higher both relative to the rest of the world and, astonishingly, in absolute terms for some services.

The NBN may be the last chance to get it right before it is too late to avoid a crisis.

BUT action is required in the meantime to protect the industry from further damage.

This requires from the ACCC a willingness to enforce and from the Government immediate commitment to incremental policy change.

Neither are occurring. In fact in some cases, we are seeing the opposite. (WLR exemption)

What we are seeing in the slow regulatory and policy response is, I fear, analogous to the petrol and grocery industries.

No one can believe that the problems of high prices and lack of competitiveness in those industries developed overnight. It was a case of the "frog in boiling water" syndrome. By the time the heat had reached such a point that pain was impossible to ignore, it was too late.

In just the same way, I put to you that a crisis will emerge in telecommunications competition. It is emerging in the vacuum that has been created by a lack of purposeful action on the many occasions when regulatory or policy action could have intervened over many years.

NBN must fix this permanently by getting the structure of the industry right. The new network must be structurally separate from any retailer.

However, we need incremental action to fix regulatory arrangements that we have known for years are unworkable. Not just because they are a problem in themselves but because they force people to take their eyes off the NBN ball at a crucial time.

Take, for example, the undertakings regime that the ACCC has been saying for years is broken and is gamed endlessly by Telstra.

Every vexatious set of undertakings presented by Telstra drags industry and ACCC resources into a pointless cul de sac.

Right now we are dealing for the third or fourth time with undertakings from Telstra claiming that the price for the unbundled local loop service should be $30 a month. This has been rejected by the ACCC and the review courts repeatedly, but again Telstra trots out the same number and plays a new round of regulatory charades.

It is easily fixed. Empower the ACCC to amend undertakings to make them consistent with its decisions in arbitrations and its model price terms and conditions.

Watch Telstra stop the gaming then, if it might actually have to live with consequences from its actions!

Or we can continue to do nothing and hope that the there is enough life left in the frog that it can be saved by the NBN decision some time next year.

That is a gamble that we need not and should not take.

Thank you

Ends

Other Data
Telstra PSTN revenue per user flat.
UK Average monthly revenue per line down 3%

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[i] This table is not and does not purport to be Average Revenue Per User (ARPU), nor the prices of specific services (which vary). It is derived from the total revenue and total line number number for wholesale and retail reported by Telstra in its annual report over the past four years to provide a snapshot that can be compared year on year. ARPU for wholesale and retail lines, (if published by Telstra) would demonstrate the same trend. ARPU numbers would be lower in absolute terms. If an average is taken across a 12 month

period while wholesale prices are rising, it would understate the actual average revenue per line at the end of the year.