

Supplementary Submission to the
Senate Environment, Communications, Information Technology and the Arts
Legislation Committee

Inquiry into the Telstra (Transition to Full Private ownership) Bill 2005 and
related bills

by

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1. Introduction

This supplementary decision is made on the basis of further information provided during the course of the public hearing.¹

It is somewhat surprising how an issue of such fundamental economic significance as telecommunications services, and the regulation of telecommunications services, is conducted in an environment totally free of economic discussion. While the administrative processes of the ACCC are full of such detail, the overarching legislative discussion is devoid of them. This brief submission addresses in a very high level manner these issues and why AAPT believes the model of operational separation proposed is inadequate, and why the proposed modification to the LTIE test could have disastrous consequences for end users.

The submission has two parts – the first is a simple run through of some key economic arguments. This is necessarily brief, and contains no diagrams or mathematical descriptions.

2. Brief review of economics

We regulate telecommunications because of the problem of monopoly – that is, that a monopolist will charge a higher price than would occur in a competitive market (in a competitive market set price equal to marginal cost). Economists are concerned about this because the higher price results in a reduction in output resulting in “deadweight loss”. They also observe that there is a transfer in surplus from consumers to producers that results in a super-normal profit usually referred to as “monopoly rents”.

It is also noted that “monopoly rents” do not always flow to investors but are usually dissipated in various forms of “rent seeking” behaviour.

The problem of monopoly is addressed by either regulating the prices the monopolist can charge or by introducing competition. The appropriate decision depends upon the nature of the industry, and to a degree a bit of both is occurring. There is direct regulation of prices, both retail price controls on Telstra and access pricing for wholesale access to Telstra services. There is also an attempt to introduce competition, both by removing the rules that reduced the restricted entry and the access regime assists.

The issue that bedevils the whole discussion is the existence of economies of scale and scope. Economies of scale mean that the cost of producing twice as much output is less than twice the cost of producing the initial output. Economies of scope mean it costs less to jointly produce two products than the sum of the costs of producing the two products separately. The large capital investments involved in telecommunications results in both these economies.

This creates both a reason why it might be desirable to have only one network (because duplicate networks destroy the economies of scale and scope) and creates a problem for price setting. The price setting problem is created by the fact that the average cost of operating the

¹ Specifically, the evidence by Simon Bryant from DCITA who suggested that the “designated services” for equivalence under operational separation would be nothing more than the “core” services, and the repetition by Kate McKenzie of Telstra their claims that existing declared services are provided “below cost”.

network is above the marginal cost. A regulated price set at average cost still creates an incentive for an integrated operator to expand outputs through its own channels by pricing closer to marginal cost; pricing access at marginal cost results in the network operator not being fully compensated.

The simplest solution to this problem is to separate the network from the retail services businesses, and at least ensure that all the retail businesses face “price equivalence”. That doesn’t mean necessarily the same price, but it does mean they face the same price frameworks and incentives to grow the overall market.

Operational separation creates a possible efficiency loss of vertical scale and scope efficiencies. These arise, for example, from the operation of common systems at the network and retail stage. Many of these are over emphasised given modern IT architecture. The more significant efficiency is around reduction of uncertainty about whether the retail channel will exercise appropriate effort in selling the network once the investment is made. This is also not an insoluble problem – but requires more complex pricing structures than the simple flat rate pricing or “take or pay” structures currently employed.

3. Current proposals

The proposals introduced in the Bills attempt to introduce an operational separation model to encourage Telstra to operate a network business separate from its retail business and to run a wholesale business to ensure equivalence of access to the services of the network business. At the same time Schedule 9 of the Competition and Consumer Issues bill requires the ACCC to take greater notice of future investments and the risks involved in investment.

Telstra clearly from their evidence believe they are being compensated “below cost” in all their regulated access services. Any change to the LTIE test can therefore be expected to result in Telstra resubmitting all previous regulatory prices setting instruments for consideration.

The suggestion in hearings that the “equivalence” regime should only apply to “core services” means that the operational separation regime is not a new regulatory construct but a very minor addition to the existing framework. In AAPT’s initial submission we raised concern about the lack of clarity and poor process for future addition to the list of “designated services”. The commentary in the Explanatory Memorandum, and the evidence presented by Simon Bryant highlights our concern.

The reason why “equivalence” and the accounting activity needs to extend beyond a small group of services is that other services can be “bundled” with the core services. If the possibility exists for Telstra to achieve even more for its declared services this creates the question of how they invest these returns. If they invest these returns by subsidising services bundled with these transparent services, they will be competing in a way their competitors can’t while complying with the “operational separation” rules. This is particularly of concern given that the operational separation conduct needs to be considered by the ACCC in exercising their powers under Part XIB and Part XIC. It is also particularly of concern when the enforceability of the operational separation plan is in doubt.

4. Conclusion

The bills in their current form has the possibility to significantly reduce the effectiveness of competition in telecommunications to the detriment of consumers.