Forum

Competition in telecommunications

The following is an edited version of a speech by Commission Chairman, Professor Allan Fels, to the Australian Telecommunications Users' Group (ATUG) in Sydney on 6 March 2003.

We are on the verge of yet another revolution in communications. The digitisation and convergence of broadcasting and telecommunications services, networks and platforms is underway. The traditional shape of telecommunications markets is shifting and altering. This is challenging established systems—particularly regulatory structures.

Economic change—globalisation, deregulation, the impact of new technologies—have worked well for consumers and competition. But we need to be vigilant about the potential for these changes to lead, in some cases, to new forms of market power, new forms of anti-competitive practices and new consumer scams. They represent ongoing challenges to consumer protection and competition law.

These are important issues in the telecommunications industry now and in the foreseeable future.

Scorecard

Over the last six years the industry has clearly transformed. Let me start by giving you a scorecard for competition in the telecommunications industry.

Despite some recent rationalisation, there are more players—the number of licensed carriers has increased from 14 in 1997 to around 90 at last count.

A range of services is offered—from landline telephony to complex mobile services and high speed broadband.

Prices have reduced most obviously in the markets for international long-distance and mobile calls.

Open competition and technological change have delivered some of the benefits of competition to the consumers of telecommunications services. The Commission concluded that the price of a full range of telecommunications services has declined by 21.4 per cent in real terms between 1997–98 and 2000–01[1] and there have been further falls since then.

However, the outcomes of competition have not really met the expectations of 1997. It may well be that we were all too optimistic in thinking that the competition rule and an access regime could by themselves deliver competitive results, given the structure of the Australian industry.

The effectiveness of competition does vary greatly across the different telecommunications markets. The Commission's analysis is that progress is slowing.

Three areas in which the Commission is currently assessing the effectiveness of competition are: the local call services market; the national long-distance and international call market; and mobile telephony markets.

Local call services market

Competition has had very little impact. Telstra owns the only ubiquitous customer access network.

Telstra's wholesale share of this market is 94.1 per cent, including basic access lines resold by its competitors.

Its main challenger is Optus, whose market share is only 5.9 per cent.

Limited competition does occur in most metro areas, but there is no competition in less densely

[1] There was a 21.4 per cent reduction in the price of a full basket of telecommunications services between 1997–98 and 2000–01. *ACCC telecommunications reports 2000–01, Report 2: changes in prices paid for telecommunications services in Australia*, p. 72.

populated areas—and no sign that this will develop in the near future.

The ubiquity of Telstra's network means that all other providers must at some point interconnect with Telstra to reach potential customers.

Telstra's control of the customer access network allows it to have significant influence over the retail prices of its competitors in all markets where access to the network is necessary.

To give an idea of proportion, the customer access network generates about $6 billion a year in revenue for Telstra, which is roughly 60 per cent of total fixed telephone revenue.

National long-distance and international call markets

Despite the appearance of strong competition, there is also evidence of ineffective competition.

Telstra has about 48 per cent of this market.

Optus has about 18 per cent.

There is some facilities-based competition from smaller entrants on major long-distance transmission routes, particularly between the capital cities. But there is no effective competition on non-major routes.

And again, most suppliers of long-distance and international calls have to access Telstra's network to reach their potential customers.

Mobile telephony services

The Commission believes a distinction needs to be made between calls made between mobile consumers, and those made from fixed lines to mobile services. For mobile-to-mobile services, competition at the retail level appears to be reasonably well established. It was further enhanced by the introduction of mobile number portability in 2001.

Consumers now have a choice of around 13 mobile providers, including resellers.

While Telstra still leads the market with a market share of 43.5 per cent, it is closely followed by Optus (32.6 per cent), Vodafone (18.3 per cent) and Hutchison (5.6 per cent).

For fixed-to-mobile services, the retail market has been growing in recent years. So much so that Telstra's recent half-year report shows it now earns more revenue from fixed-to-mobile services than it does from national long-distance services. This is despite the fact Telstra carries more than double the number of national long-distance minutes than it does for fixed-to-mobile services.[2]

Unlike the market for other fixed line services—such as national and international long-distance—there has been relatively little reduction in the final prices paid by consumers in recent years for fixed-to-mobile services. Further and perhaps related, there appears to be limited competition in terms of wholesale mobile termination. This is of concern to the Commission.

We have noticed recent international developments in terms of mobile termination; British, Italian and French regulators have recently acted to reduce mobile termination charges.

We implemented a novel benchmarking approach for determining mobile termination prices a few years ago and at the time noted that we would need to review its progress. Accordingly, we will undertake a major inquiry into mobile termination in the near future.

The Commission will also use this opportunity to undertake a broad review of several other related regulatory issues associated with mobile telephony services such as mobile origination, domestic and international roaming, and others.

In summary, despite the emergence of some facilities-based competition, mainly in the central business districts of major capital cities, few of Telstra's competitors have any real alternative to the extensive use of Telstra's network services as an input to providing their own services.

The second largest player in the industry, Optus, is in a better position than other smaller players in the market, but still relies heavily on access to Telstra's customer access network to provide national coverage. There are also supply relationships between Telstra and Optus for services like data interconnection and local call resale and it also relies on key inputs from Foxtel, which is 50 per cent owned by Telstra.

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2 Telstra's recently reported half-yearly retail revenue for fixed-to-mobile and national long-distance services was $746 million and $579 million respectively. The combined wholesale and retail minutes carried for each service was 1955 million and 4656 million respectively. While minutes include both wholesale and retail, wholesale minutes represent a very low proportion for each service.

Rather than leading to the promotion of vigorous 'head-to-head' conduct this situation is more conducive to more cautious 'follow-the-leader' conduct. The slower growth environment over the last few years compounds this problem.

Market power

The clear message from this analysis is that Telstra has overwhelming dominance in almost every segment of the telecommunications market.

It is one of the most horizontally and vertically integrated telecommunications companies in the world. It:

- controls the local telephone network
- is the largest mobile carrier with two advanced digital mobile networks
- is the largest retail ISP
- is the largest provider of wholesale data and internet services
- is a 50 per cent shareholder in the major pay television cable network.

Neither British Telecom nor any of the US telecommunications companies have the same level of integration, market dominance, and in the US case, national coverage, that Telstra does.

Telstra's market power derives not merely from its market share but from its control of inputs essential for downstream services.

It will retain control over critical inputs for many services for the foreseeable future. It has had the advantages of an incumbent: a large starting share of the customer base and a close knowledge of these customers; deemed protection from competition before 1991 and from its position in the 'managed duopoly' arrangements of 1991–97.

The existence of such extensive market power is a major risk to competitive outcomes as it has both the ability and, importantly, the incentive to try and thwart entry into complementary and substitute markets by other companies.

Telstra has also demonstrated a willingness to use its market power to game the regulatory regime and delay competitive outcomes.

There are numerous examples from all aspects of the Commission's work.

In mid-2002, after a delay of nine months, Telstra finally adjusted its conduct in the wholesale ADSL market. The Commission had notified Telstra formally in September 2001 that its conduct was breaching the competition rule. As a direct result of the Commission's action wholesale prices came down during this period by 25 per cent.

Telstra used delaying tactics for around 18 months in the appeal to the Australian Competition Tribunal on the Commission's final decision regarding the PSTN arbitration, before settling the matter. This was all before hearings on the substantive merits had even started.

Perhaps the clearest illustration of my point about the anti-competitive effect of Telstra's market power is in the analogue pay TV market.

The Commission has been trying to open up Foxtel analogue pay TV services to competition since 1998. We used all of our powers under the access regime to make this work. We:

- declared the service
- arbitrated a number of access disputes
- issued interim decisions outlining terms and conditions on which access had to be provided.

And still there has been no outcome.

Even with the Commission applying its powers to the full, Telstra and Foxtel have continued to deny access to the pay TV cable and content.

The Foxtel/Optus content sharing arrangement was a defining moment for the pay TV industry.

The Commission accepted court enforceable undertakings from Foxtel, Optus, Telstra and Austar for these arrangements in November 2002.

We made it clear at that time that the undertakings were not intended to alter the pre-existing competitive landscape in the pay TV industry, and that the Commission's decision related to the specifics of the case under consideration.

In this case there was evidence that the competitive position of Optus in the market was being adversely affected by its inability to access and supply key content to it customers. The content sharing arrangements should enable Optus to improve its programming and to ensure consumers are offered a better quality pay TV service.

The court enforceable undertakings accepted by the Commission last November will also provide for rival pay TV operators like TransACT and Neighbourhood Cable to purchase a more comprehensive range of programming. This will

enable them to offer consumers a broader range of programs including popular movies and sports.

It should also allow rival pay TV operators to use Foxtel and Telstra's analogue and proposed digital pay TV infrastructure—such as Telstra's cable network and Foxtel's set-top boxes—to provide competing services to consumers. However, there are a number of processes still to be completed, so even here there are no complete outcomes at this time.

The Commission is also now considering an application lodged by Telstra and Foxtel in which they are seeking an exemption from access obligations, should they go ahead with the digitisation of the Telstra cable and Foxtel's set-top units. I must emphasise that this is a different and separate task to the consideration of the undertakings that occurred in November.

The Commission continues to have broader concerns about the level of competition in the broadcasting industry, in particular, bundling of services, access to content and the regulation of set-top units.

We also have concerns about the future convergence of broadcasting and telecommunications services; it is possible that Telstra could use its dominance in one market to leverage power into a converged market.

While ultimately the processes and outcomes of convergence remain somewhat uncertain, the absence of effective competition now may serve to restrict the nature of convergence to what suits the interests of dominant firms and close the avenues for new competitors.

Telecommunications regulatory arrangements

The Commission has now been regulating the telecommunications industry for six years. As in all its more general activities, it has sought to be a rigorous but enlightened regulator and remains committed to following this path in the future.

However, having developed considerable experience during this time, we have of course formed views about the regulatory regime.

Like many in the industry the Commission has become increasingly concerned at the slow pace at which competitive markets have emerged.

It is no secret that I have strong reservations about our particular form of access regime; you have all heard my views on the 'negotiate–arbitrate–re-arbitrate' system before.

While the Commission is not opposed to normal appeals on points of law, it is opposed to full re-arbitrations and has strongly advocated the removal of re-arbitrations of Commission decisions. I warmly welcome the government's recent amendment in this regard.

However, given the level of market power that Telstra wields in the industry, it is arguable whether any access regime could—on its own—deliver fully competitive outcomes to industry.

It is generally acknowledged that access regimes have inherent problems. They:

- may not provide for timely outcomes
- lead to gaming from both access providers and access seekers
- can be a source of uncertainty
- have significant regulatory costs.

These problems stem from one of the main deficiencies of access arrangements—they do not change the underlying incentives of a firm to provide fair, timely and non-discriminatory access to its upstream inputs where it also competes in downstream markets.

In 2001 the OECD Council of Ministers adopted a recommendation on structural separation of regulated industries urging member countries to seriously consider structural separation when in the process of liberalisation and regulatory reform.[3]

A recent draft working paper from the communications section of the OECD has expressed some reservations about the practical difficulties of structural separation, but the ministerial resolution still stands as the expression of agreed OECD views.

Some options for regulatory reform

One of the options for reform is accounting separation.

This would require the integrated carrier to collect information and report separately to the regulator on its wholesale and retail businesses.

This form of separation is nominal; it relates to information collating and reporting.

It does not strictly require the carrier to re-organise its internal affairs to operate as if it were operating two or more separate businesses.

3 OECD, *Restructuring public utilities for competition*, Paris, 2001.

As such, it does not alter the incumbent's incentives.

We already have a form of accounting separation in the current regime through the regulatory accounting framework.

The government's recent changes to the Trade Practices Act will augment the regulatory accounting framework by introducing:

- current cost accounting
- ongoing imputation tests
- ongoing monitoring of wholesale and retail provision of services.

This will mean that the current framework will better reflect efficient costs, which can more readily be used to examine access pricing and below-cost pricing concerns. It will also improve general transparency about Telstra's conduct, and facilitate detection of anti-competitive conduct.

However, we should be cautious in creating false expectations about this regime. There needs to be a clear understanding that accounting separation is not designed to, and cannot force, a change in a carrier's underying incentives or conduct. The extent to which it improves the competitive environment therefore depends not only on the degree of transparency it provides, but also the other regulatory tools to respond to competition problems identified.

Further, both in implementation and on-going compliance, Telstra's full cooperation in committing appropriate resources to this process will be vital to ensure the regime works as well as possible.

Over the last few months the Commission has observed Telstra's reluctance to give accounting separation the priority that it will require if accounting separation is to meet the government's objective of producing a more transparent, open and competitive environment. The Commission looks forward to Telstra's attitude changing for the better in the near future.

To return to the OECD again, in 2001 it argued that in the absence of structural separation, successful regulation depends on the regulator being given appropriate instruments of control, information and resources.[4]

The government's recent accounting separation amendments and introduction of benchmark terms and conditions for core services aim to strengthen these parts of the law.

The benchmark terms and conditions for three core services (PSTN, ULLS and LCS) will be published in the middle of this year. They will provide access seekers with an idea of the prices that the Commission would most likely set in arbitration. This heightened level of transparency should assist them in negotiating outcomes with access providers.

Nevertheless, as I have already noted, there are inherent limitations in the accounting separation framework.

While on this topic it is worth discussing operational separation or ring fencing, as currently applies in some energy markets.

This builds on accounting separation, with some further changes to the firm's organisational structure.

It has the effect of physically separating the various business of the carrier. The network business would be separate from the retail business, with separate management, and some form of internal transfer pricing used to manage the relationship between the entities.

It would provide a stronger requirement on an integrated carrier to refrain from discriminatory behaviour; stronger than accounting separation. And it would be easier to monitor.

But, as with accounting separation, it does not change the underlying incentives for the firm as a whole.

Against this background the Commission was asked by the Minister for Communications, Information Technology and the Arts to report to him on emerging market structures and their effect on competitive outcomes. Obviously, I do not wish to pre-empt what we will say, but it is likely that the report, which we would like to complete within a month, will:

- outline the key competition concerns that arose during the Commission's consideration of the pay TV content supply agreements last year
- discuss current telecommunications and broadcasting market structures
- examine the regulation of the pay TV industry, including access to content and bundling.

4 OECD, *Policy Brief—when should regulated public utilities be broken up?* August 2001, p. 3.