

28 March 2008

Ms Patricia Scott
Secretary
Department of Broadband, Communications and the Digital Economy

By e-mail to nationalbroadbandnetwork@dbcde.gov.au

Dear Ms Scott

I am writing to you as Chair of the Panel of Experts appointed by the Minister for Broadband, Communications and the Digital Economy, Senator the Hon Stephen Coroy, to assess National Broadband Network proposals.

I am writing primarily as a concerned citizen, but also as a concerned citizen who has had recent direct experience in the policy and regulatory processes that have brought us to the current process. In this letter I wish to touch briefly on issues that I think should frame the panels approach. In the course of this I will refer to two attached documents. The first is a submission I made to the earlier in response to the "Draft Guideline for High Speed Broadband Network Infrastructure Proposals" (referred to as **my earlier** submission). The second is the draft of a submission prepared for the Australian Competition and Consumer Commission (the **Commission**) in response to its draft decision to reject the FANOC undertaking, a submission that was only finalised the day FANOC withdrew its undertaking (referred to as **my FANOC submission**).

The current policy and regulatory position is due to the observation that broadband services are not uniformly available around Australia. But unlike a range of previous issues, the pattern of availability is not only delineated on a country/city divide, but also on an entirely anachronistic basis of how far customers are from pre-existing telephone exchanges.

The new Government has announced that it is prepared to provide up to \$4.7B in funding to achieve a stated goal of 98% of households receiving a 12Mb/s service. This is an advance on the previous Government's policy that set up an effective tender for Government policy without being explicit about what the service delivery requirement was to achieve the requested policy change.

The decision the Government will make based on the advice of the Panel of Experts is far bigger than the decision relating to funding. The decision will determine service availability and industry structure over the next ten to twenty years. Few question the repeated claims that an access network has economies of scale and scope, which are sufficient conditions for describing the asset as constituting a natural monopoly.

Judging by the claims published in ACA and now ACMA reports of the benefits to the economy from the introduction of competition in

telecommunications, the financial dimension of the task is far bigger on the outcome side than the input side.

I wish to humbly suggest that the Panel incorporate X simple principles in their request for proposals documentation. These are;

1. Documented evidence that the proposer has entered into detailed discussions with potential wholesale customers of the network, and that the wholesale customers are supportive of the proposal.
2. That the Panel will give preference to proposals that result in the National Broadband Network being provided in a structurally separated way from any retail provider.
3. That the Panel will give preference to proposals that seek to first serve "underserved" areas (typically exchanges without any DSL infrastructure and areas where copper runs from existing exchanges or other cabling limitations reduce service availability).
4. That the Panel will give preference to FttN proposals that outline the future method and likely cost of extending the network to a FttH network.
5. That the Panel will favour pricing proposals that are based on full disclosure of costs, and pricing based upon recovery of these costs rather than attempting to determine fixed future prices. The Panel will also consider pricing options that include "two part" tariffs including plans that provide a discounted rate for customers prepared to contribute to the financial success of the network by forward committing to capacity.
6. That the Panel will favour proposals that involve new capital raising rather than just dividend re-investment as new capital raising can solve a perennial regulatory problem of determining a cost of capital.

I will address each briefly.

Evidence of support from future customers

As I outlined in my earlier submission the process to date has seen the various parties driven away from each other in a contest for regulatory favour (though it has been inaccurately described as a contest for the market). No matter what the outcome it is to be hoped, given the scale and scope economies inherent in the access network, that all current service providers would be users of the network. The G9 response to Telstra's initial FttN proposal was to welcome it but seek a guiding body (SpeedReach) to oversight the terms of access, and if Telstra's requirement for the creation of such a body was for others to also invest then they would invest. However, if Telstra refused the suggestion and refused to build the network then they would propose their own.

The G9 members first preference was to have all the interested parties at least talking.

It is hard to identify a way to force the parties to talk, but one way would be by favouring proposals that can demonstrate that they have been discussed, and ideally supported, by future customers. The Panel could assist the process by creating a register of intending wholesale customers that proposers could formally discuss proposals with.

Structural separation

In my FANOC submission I note the Telstra response to the way that the Commission made passing reference to the Commission's view that in the case of a structurally separated entity the need for regulatory oversight would be "relatively low". In that submission I outline and dismiss the few arguments Telstra has ever publicly mounted against structural separation. I go further to suggest that the recent High Court decision provides greater comfort for the Government were it to require structural elements to the access regime.

It is hard to accept that anyone can seriously advance the proposition that the integrated player achieves some benefit from vertical integration, and yet the integrated firm's wholesale customers obtain full "equivalent" service.

If a proponent wishes to advance an integrated model, then the source and application of the integration benefits should be exposed in a fully quantified model, not continue to be made by little more than assertion – an assertion which in Telstra's case amounted to nothing much more than the idea that Sol Trujillo is a better central planner than Joe Stalin.

Serving the underserved as a priority

A major concern of Telstra's competitors over the FttN proposals was that Telstra would implement on an "exchange by exchange" basis, and the most commercial exchanges to address were those with competitor DSLAMs. That is, render competitor investments redundant as quickly as possible.

But the unmet need is in patches around some, mostly outer metropolitan, exchanges. Building FttN infrastructure selectively to need would potentially be a more expensive deployment, but would be socially optimal.

One weakness is in having real clarity on not just where the nodes are but how well customers are being served. A "national broadband speed test" with mapping would not be hard to achieve. A small client that asks the user for their address, the name of their service provider (and plan) can take an automated speed test and return the results to a central point for mapping. The IP addresses of respondents can be checked against IP address allocations (especially to distinguish the real IP provider).

Future development

To allay concerns of those who worry the Government may be buying a "white elephant", a network surpassed before it is built, proponents can be required to show their migration plans.

Ideally these migrations plans would allow for individual users to fund their own or shared FttH connection in advance of a whole node cutover.

Cost based pricing

The Commission has expended hours on determining "cost based" prices to mirror what would occur in competitive markets. In this case much of the asset is new asset, and it is thus easier to cost it based on real costs.

The provider needs to be prepared to share their cost data ultimately with their customers. The pricing structure then needs to provide the guaranteed return to the provider of their costs.

New finance

If the provider develops an open pricing model to recover costs, the overall investment takes on a lower risk profile, certainly lower than that of any of the stocks of existing telcos.

There are many fund managers looking for stable secure investments. The more the fundraising is conducted outside the existing telcos the cheaper the finance cost is likely to be.

I wish the Panel well in what looks to be a difficult task. There are many ways the Panel can seek to gain the kind of co-operative participation in access network building that the world has experienced in some undersea cable developments. The Panel needs to be aware of the incentives of the players, and the ways the Panel and Government can adjust those incentives.

I would request this submission remain confidential until agreed to release by me.

Yours sincerely,



David Havyatt
Principal

**Submission in response to the invitation to comment on
“Draft Guideline for High Speed Broadband Network
Infrastructure Proposals”**

Introduction

1. This submission is made by Havvyatt Associates in response to the invitation to comment on “Draft Guideline for High Speed Broadband Network Infrastructure Proposals” (the **draft**). Havvyatt Associates is not representing any client in preparing this submission.
2. The Government, in seeking proposals for high speed broadband proposals in this way, is acknowledging the view that Australia cannot expect the deployment of competing fixed broadband networks in covering five capital city markets. However this acknowledgement is not well represented in the draft, variously appearing with confusion about whether respondents should be addressing retail or wholesale markets.
3. The draft continues the inadequate policy consideration that the way forward is a choice between one of the two proposals already subject to public discussion, or some new proposal. The draft doesn't provide an incentive to bring the potential users and constructors of the network into productive dialogue. It would seem to be desirable for this dialogue to occur given the position that there will be only one network.

Objectives

4. The objectives while relatively clear they nevertheless build on the vagaries of the existing regime's definitions of long-term interest.
5. There is one specific objective that requires greater explanation. This is the objective in paragraph 3.1(b)(iv) “the ability for the investor to earn a commercial return commensurate with its costs and risks of investment”. This paragraph reflects the prevalent view that there exists, with some kind of separate ontological commitment, an appropriate rate of return for any specific investment. In the real world rates of return are determined by markets, they represent the price investors need to make their funds available. As such, the appropriate return for each proposal is “endogenous” to the proposal; it is a function of the structure of the proposal not a hurdle which the proposal must otherwise meet.
6. As an example, the rate of return expected from a new monopoly infrastructure asset protected from competition and with little competitive threat is different to the rate of return expected from a growth stock in a risky market, or indeed a historic monopoly that has been auctioned off with embedded monopoly rents.
7. Any prospective respondent has access to the same pool of global technology providers. As such the major distinction between potential

proposals will be “deal structure”, not technology. Operating expenses will also be similar. Consequently, the major difference between the cost to consumers of competing proposals will be the cost of capital inherent in them. As a consequence, rather than the investors earning a commercial return commensurate with risk being an objective, the rate of return expected should be one of the major factors for choosing between proposals.

8. The objectives in paragraph 3.8 reflect confusion as to the expected nature of proposals; as it says the proposed infrastructure should provide a range of wholesale access and retail services. The network is supposed to be an open access network – so hopefully the retail services will be provided by more than just the proponents. Requesting details of retail services may artificially advantage a vertically integrated provider.
9. Paragraphs 3.11 and 3.15 both refer to USO matters. It does seem to be problematic that there is a USO review in conjunction with the expert taskforce. It would be preferable that the USO regime be considered part of the rules and regulations being “tendered for”.
10. Paragraphs 3.17 to 3.23 provide a number of requirements about wholesale access that proponents must address. However, all of this is constructed in the manner of a discussion about wholesale access akin to the ACCC’s access undertaking process, that at least allows for consultation with potential access seekers before approval. This deficiency could be addressed in such a way as to create the opportunity for convergence of proposals. This could be achieved by requiring proponents to provide evidence of acceptance of the proposed wholesale regime by expected wholesale customers.
11. Paragraphs 3.24 and 3.25 are again about return on investment. The earlier comments are repeated. The proposal that incurs the lowest cost of capital should be preferred.

Assessment Criteria

12. The assessment criteria at paragraph 4.6 refers to competition assessments in “relevant markets”. Market definition alone can occupy half an ACCC declaration inquiry. If there are relevant markets the taskforce will consider, these should be explicitly defined in the guidelines by the taskforce.
13. The last dot point of paragraph 4.6 asks for comment on the likely impact of proposals on “market concentration”. It is actually to be expected, and desired, that the “winning proposal” will result in a concentration of the market at the infrastructure level. An effective access arrangement should result in greater diversity at the retail level, and asking respondents to demonstrate how their proposal will increase diversity and choice in retail services is reasonable.
14. Paragraphs 4.6 and 4.7 expect proponents to definitively comment on specific outcomes for retail services about what is essentially a wholesale network. These paragraphs should be rewritten to talk

about how the access regime would facilitate retail outcomes, not the actual outcomes.

Assessment Process

15. The expert taskforce is supposed to be a public process to “depoliticise” the decisions about the future network build. As a consequence the proposal at paragraph 5.17 that the release of the final report will be a matter for the Australian Government should be changed to require the Minister table the report in the Parliament within fifteen sitting days of its delivery (similar to the requirement on Productivity Commission reports).

Conclusion

16. The changes to the draft proposed in this submission will not completely rectify a flawed process. They will, however, create some incentive for industry players to talk to each other. There are better ways to achieve this outcome.

DRAFT

Submission by Havvatt Associates Pty Ltd

**to the Australian Competition and Consumer
Commission**

**in response to
“Assessment of FANOC’s Special Access Undertaking
in relation to the Broadband Access Service: Draft
Decision, December 2007”**

Introduction

This submission is made by Havvyatt Associates Pty Ltd to the Australian Competition and Consumer Commission (the **Commission**) in response to the *Assessment of FANOC's Special Access Undertaking in relation to the Broadband Access Service: Draft Decision, December 2007*. This submission is made on behalf of Havvyatt Associates and not on behalf of any client nor should it be considered representative of the views of any organisation with which the principal of Havvyatt Associates has had any prior association.

The submission addresses only one aspect of the draft report which has been highlighted by Telstra, being the Commission's observation that a structurally separated provider may require a lower level of regulatory oversight. Telstra saw fit to devote considerable attention to the question of structural separation in its submission on the undertaking, and took further exception to the Commission's comments in the draft decision.

As this matter is largely tangential to the actual consideration of the FANOC undertaking, Telstra's arguments would not normally warrant direct rebuttal. This is particularly so since policy makers have assumed that there are insurmountable hurdles in the way of creating a structurally separated industry, most particularly a concern about the perceived interference in Telstra's property rights.

However, the decision in the High Court of Australia on Telstra's request for an examination of the constitutionality of the access regime may change that position.¹ The Court found that Telstra's property rights were limited by the existence of the requirement for access to be provided prior to the PSTN asset being transferred to Telstra. There has been some suggestion² that the decision might be restricted to only those assets transferred, however all the other assets have been investments made in the existence of the access regime. In fact, Telstra's own behaviour of its Fibre to the Node (**FttN**) plans demonstrates their understanding that these new investments are subject to the access regime.

Consequently it would appear to be open to policy makers to require Telstra to organise itself in particular ways, including separating the ownership of certain assets, if that facilitated the development of the access regime. Thanks to Telstra's actions the legal risk has been greatly reduced.

Therefore Telstra's arguments in these proceedings on the subject of structural separation become more relevant. They appear to be the only substantive comment by Telstra on the matter since their submission to a

¹ High Court of Australia 2008.

² Telstra 2008(a)

House of Representatives committee review of the matter (Telstra 2003). The arguments are, like most telecommunications regulatory arguments, presented in the most one-sided and extreme manner possibly, and are at times inherently self-contradictory. As we shall see no weight should be given to them in considering the prospects for structural separation.

This submission discusses Telstra's three submissions on structural separation (in 2003, in response to the FANOC undertaking and in response to the draft decision), and then considers matters that Telstra doesn't discuss. It concludes with the suggestion that Telstra's claims be subjected to greater scrutiny in the consideration of policy options for the next generation of access networks.

Telstra's submission in 2003

Telstra's first explicit argument on the question of structural separation was laid out in response to the House of Representatives Standing Committee on Communications, Information Technology and the Arts: Inquiry into Structure of Telstra. In its submission Telstra (Telstra 2003) advanced four fundamental arguments;

1. Any break-up would be arbitrary and impose significant structural rigidities, which hamper innovation and technological improvements,
2. Structural separation would impose significant costs on Australian consumers, based both on lost efficiencies of integration and the additional systems costs for separation,
3. Separation will reduce the operating efficiencies that are currently used to help fund uneconomic services, particularly in regional and rural Australia, and
4. Structural separation will send strong negative signals to investors as such a dramatic policy intervention increases sovereign risk and runs against the trend of regulation around the world.

The consideration of these arguments now is slightly changed, because the context is not about a mandatory separation based on existing technology, but on the possibility of separation in conjunction with the deployment of Next Generation Networks (**NGNs**) and FttN.

The first concern is the choice of a boundary point between the separated businesses. This was indeed a challenge, but Telstra themselves over estimate the clarity of the dividing line between local and long distance calls (see AAPT 2003 P.9), though they are correct to identify a clear dividing line between national and international calls, and there was a very clear line between intra-state and inter-state calling in the USA. The boundary between the access network and the core network is relatively clear in an NGN environment, especially under the network architecture envisioned by Telstra (Telstra 2005).

The concern about additional cost for consumers has two elements, the second of which (relating to additional system costs) includes a cost for the necessity to introduce new systems outside of a normal system cycle. Were the separation to occur together with a major technology change such as the NGN or FttN proposals, the only question would be whether there are lost benefits of integration. These can be thought of as lost scope efficiencies in IT. The first part is an efficiency argument addressed further below.

The third concern is at best spurious, as the accepted policy position is that Telstra should be compensated for providing uneconomic services. There is merely a dispute over the facts of how much this compensation should be.

The fourth concern may have some substance, however there is no sovereign risk involved as such because in the terms of the High Court decision there is no policy change. That Telstra may have misrepresented its property rights to shareholders is not a concern that should influence policy.

So the arguments against separation are either technology concerns about the operation of separated elements or about lost efficiencies.

The argument about technology occurs in two parts. The first is about the integrated nature of even notionally layered technical reference models, namely "ensuring a service works and works reliably often requires a degree of integrated control between and within layers." (Telstra 2003 P. 21) This cannot be sufficient justification for integration, as many aspects of the economy require similar co-ordination of "control".

The second argument on technology is what Telstra calls the "chicken and egg" problem, and the example they give is of the development of Viatel and the question of how to get users without content, and content without users. They conclude, "from these experiences and others, Telstra has learnt that resolving or avoiding "chicken and egg" problems requires coordinated investment across all elements necessary for service viability" (Telstra 2003. P.24).

This is an extraordinary conclusion given that the eventually successful model of on-line services was the Internet, which was always a development without "coordinated investment" and was indeed a model that trumped every instance of proprietary or walled garden models. The other example Telstra offers is of the content requirements on Pay TV and ignores entirely both the initial dynamic (excessive and wasteful network duplication) and the endpoint (common content on both platforms).

Telstra's final argument then is the efficiency argument. Telstra only spends 33 lines attempting to make this claim, and it is based on loss of scale and scope economies. As these arguments will feature later they will be quoted at length.

Economies of scale exist whenever the costs of production fall as volume of production increases and economies of scope exist when there are cost savings from performing two or more different economic activities at the same time. Economies of scale and scope are prominent features of the telecommunications industry. Moreover, vertical economies of scope between upstream and downstream markets are usually important in telecommunications as compared with other regulated industries. (Telstra 2003 P, 29)

Telstra response to the FANOC special access undertaking

Telstra's second set of explicit arguments for vertical integration has been made in response to the Special Access Undertaking lodged with the ACCC by FANOC in relation to a fibre-to-the-node network (Ergas 2007 and Moresi 2007). These arguments have been mounted because a consequence of the FANOC approach is the creation of a structurally separated access network.

Ergas (2007) identifies four "vertical externalities" which he claims result in efficiency increases from vertical integration; pricing, service quality, investment and on-going adaptation to change.

The first element on pricing is built on a simple argument from the issue of double marginalisation. Double marginalisation is an exercise in the economic theory of industrial organisation that can be shown to occur when two vertical stages are monopolists and hence face downward sloping demand curves. The simple conclusion of the model is that the profit maximising decisions of both firms result in output in the downstream market being less than output in that market were the production decision to be made by an integrated firm. This has the effect that the deadweight loss to the economy is greater than would be the case for integration and that the economic profit (rents) made by the two firms is less than the economic profit of the integrated firm (as the output is less than the profit maximising level of the integrated monopoly). As a public policy argument Ergas is only advancing the proposition that integration enhances welfare.

To make the argument work Ergas relies on the fact that even in a competitive market, all firms in reality face some downward sloping demand curve, that competition never really fully works to make the firm able to increase profit by setting output slightly lower than would occur in a competitive market. This makes this argument on its own an extraordinary claim, because clearly it must apply everywhere; economic efficiency and welfare would be advanced if everywhere in the economy vertical production stages were integrated. As this would occur everywhere and there are certainly economic efficiencies in "natural monopolies" the conclusion of this argument is that the welfare

maximising approach is to manage the entire production of the economy in one integrated firm.

The error in the reasoning is to move from every firm facing a downward sloping demand curve to every firm facing a sufficiently downward sloping demand curve to make a difference. In telecommunications especially policy makers have focussed at the very least on creating competition between downstream service providers to try to reduce the market power of each individually. To observe that some firms in the downstream market (typically the former monopolist's integrated operations) have sufficient market power to make a difference simply suggests there is something wrong with the historic approach to introducing competition.

The second argument of Ergas is described as the externality of product quality. Ergas argument gets confusing because he primarily talks about decisions made by the downstream firm but includes in his reasoning the consequences of investments by the upstream firm, while this co-ordination of investment problem is notionally his fourth concern.

The case without upstream investment appears to be that an innovation by one downstream firm would create the opportunity for other downstream firms to "enter the market developed at great risk by the innovating rival". But this spill-over issue doesn't only exist in cases where vertical integration is an issue (other than the investment co-ordination aspect). It is not a separate argument to the investment co-ordination argument.

The third argument is the vertical externality of investment resulting in hold-up. In this case once one party has made an investment that is relationship specific the other party may have an incentive to behave opportunistically on the basis that the investor has little opportunity to use the investment. While a theoretical possibility the fact that the market isn't a bilateral monopoly makes this unlikely, as in the specific case of the upstream being the capital intensive area the upstream investor has multiple downstream parties to whom the benefits delivered from the enhanced facility can be provided.

Ergas' final concern is the need for "adaptive, sequential decision-making" where uncertainty over changed circumstances is resolved over time. This would cover the case of the need for both up and downstream firms to invest in, for example, faster speeds and would incorporate the risks of spill-over if only some downstream firms assisted in the upstream investment. It is, however, broader covering cases where the investment decisions are different with different risks. In this example the upstream firm invests in a capability that the downstream firms don't buy, or don't buy in the quantities forecast.

This is, in essence, the real issue that needs to be resolved. But Ergas states "it may be difficult or impossible to completely specify the terms of trade before future uncertain outcomes have materialised", which is the classic transaction cost efficiency basis for vertical integration. The

difficulty is that while the contracts may be difficult, there is no attempt in this reasoning to quantify the difficulty in contracting. There is no attempt to consider the structure of tariffs that might apply to those contracts.

There are, however, many other economists who make a profession from designing contracts for this kind of circumstance. To repeat three times that contracting might be difficult or impossible is not the same as demonstrating that it should not, or could not, be done.

Moresi (2007) on the other hand attempts to demonstrate that there is a “dynamic” benefit from vertical integration. His argument is that under the integrated model proposed by Telstra, Telstra has both a greater incentive to invest in enhancing the copper and in innovating in the downstream market.

It is an interesting conclusion, but it is nothing more than the same observation made by Ergas in relation to the double marginalisation problem. Ergas, however, only argued the welfare enhancing value of increasing output from the separated output level to the integrated output level. However, as this level of output is lower than the profit maximising output of the integrated firm facing the downward sloping demand curve's, the integrated firm would increase output to increase rents.

This is the Moresi conclusion, there is more rent to be made by the integrated firm. The “incentive to invest” being the rent.

Is the fact that the so called “incentive to invest” is merely the opportunity to increase rent a problem, if it has the benefit of increasing output. Once again, it depends on exactly how much the demand curves are downward sloping and any policy that can improve the effectiveness of competition in the downstream market has the same net effect of making the output level the same as the output of an integrated monopolist. If structural separation, by facilitating entry in the downstream market or by removing the opportunity for the integrated firm to use its upstream power to behave anti-competitively in the downstream market, can achieve the same outcome it is to be preferred over integration. It would only be if the downstream market could not be made effectively competitive that the arguments for integration should be accepted.

Telstra's response to the draft decision

Telstra continued its concerns about structural separation in its response to the draft decision. Telstra took umbrage over one short paragraph in the decision where the Commission stated;

The ACCC also considers that a vertically separated ownership model could reduce incentives for the access provider to discriminate between downstream users of the access service and, therefore, facilitate strong and effective competition between access seekers in retail markets. Where such an ownership model is

in place, the ACCC considers the need for regulatory oversight of non-price terms and conditions of access, in particular, could be relatively low.³

In its response Telstra takes a surprisingly interesting turn (Telstra 2008(b)). Where they had previously argued (Telstra 2003) that a difficulty of separation was choosing a network boundary, they now argue that NGNs are “less vertically integrated technology” offering a “more natural access point” and claiming that the internet-based and new media economy has shown “assets and businesses above the transport layer are highly replicable by non-network providers” (Pp 7-8).

Telstra’s conclusion is that non-discriminatory access can be easily supplied. But says Telstra, while the risks of vertical integration are reduced for access seekers, vertical integration is important for the upstream provider. It is important for the investment coordination reasons given above, though this time phrased as “securing efficient, coordinated management and progressive upgrading over time.”

At the same time Telstra claims it has a “powerful incentive to quickly promote retail uptake through all of the available channels” (P.8) though a non-integrated operator has less incentive to upgrade its network “because it does not share in any margins accruing downstream” (P.9). These are hard, if not impossible positions to reconcile. The second claim is actually a feature of the earlier “double marginalisation” argument, because the incentive Telstra seeks is not “margin” as an accountant sees it but “profit” as an economist sees it, that is above the cost of supply including the cost of capital, and vertical integration of back-to-back monopolies increases rents.

As an incumbent Telstra’s arguments on vertical integration lack coherence. Once the argument against separation is separated from the argument against enforced separation, then the arguments resolve down to two. The first is that because the incumbent has significant market power in upstream and downstream markets, integration both expands output (welfare enhancing) and increases economic profit. The second is that there are transaction cost savings from integration.

What Telstra in these proceedings never does is talk about the reasons why separation might be beneficial. As we saw in the discussion of double marginalisation that could in theory apply everywhere in the economy, so there must be other factors that mean firms don’t integrate everywhere.

What Telstra doesn’t discuss

There are a number of simple issues that Telstra never discusses in its discourses on vertical integration.

³ ACCC 2007

The first is the nature of capital markets, and the fact that different assets get priced in different ways, and the related fact that investors do not favour firms with diversified risk profiles, preferring instead to build their own portfolios of risk. The combination of the utility access network business together with the potential growth business in services is a sub-optimal outcome for investors.

The second is that Telstra never attempts to quantify the scale and scope economies it claims to achieve from integration, they are just asserted. But while asserting the scale and scope economies Telstra also avoids the obvious conclusion, that the part of their business that is covered by such economies constitutes a natural monopoly. Of course any of the economies that are purely horizontal (in the same production stage) are not affected by the decision to be integrated or not, and the efficiencies can be supplied to their wholesale just as their own business. However, Telstra wants to claim these economies here but at the same time argue that competing firms should be required to replicate these facilities, which would be economically wasteful, economically inefficient and ultimately also against the interests of Telstra's own shareholders.

The more significant claim is that there are vertical economies of scope, but no attempt is ever made to quantify the economies of scope. The existence of such economies of scope would mean the project of access based competition was doomed to failure, as the access seekers are necessarily always going to be operating a higher cost model. However, the alternative of competition through fully integrated players is also doomed to failure as no entrant will ever reach the scale to match the scale efficiencies of the incumbent.

The conclusion is either that the whole project of introducing competition in telecommunications is doomed to failure, or that Telstra consistently overstates the scale and scope economies, especially the vertical economies of scope. We, of course, don't know anything about these economies because they are regularly asserted but never estimated.

There is good reason to believe that Telstra does over-estimate these economies. This is because they regularly discuss the complexity of their systems environment which are largely the creation of building vertically integrated systems. Clear separation between infrastructure and customer service systems transacting on an "arms length basis" has the potential to deliver significant savings.

Conclusion

Telstra's arguments of the benefits of vertical integration are often contradictory. At their core they are based on the supposed economies of scope and scale that Telstra frequently asserts.

The recent High Court decision means that policy makers can afford to be more robust in their assessment of the options for the establishment of

access regimes. The technology evolution to next generation access networks, particularly FttN creates the opportunity for revised consideration of the benefits of structural requirements in the access regime.

As Telstra has consistently failed to quantify the supposed efficiency benefits the assumption should be made that the quantification would not provide strong support for the argument (because otherwise they would provide the quantification).

The Commission should reconfirm their view on structural separation in their final report and communicate with the Minister the view that policy considerations should include the options of structural elements to the access regime.

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