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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

REVIEW OF TELECOMMUNICATIONS SPECIFIC COMPETITION REGULATION

PROF R.H. SNAPE, Deputy Chairman
MR M.C. WOODS, Associate Commissioner

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON MONDAY, 14 MAY 2001, AT 9.38 AM

PROF WOODS: Welcome to the draft report hearings for the Productivity Commission inquiry into telecommunications specific competition regulation. I am Mike Woods and I am the presiding commissioner for this inquiry. I am assisted in this inquiry by Richard Snape, who is deputy chairman of the commission. We released our draft report on 29 March this year. It covers Parts XIB and X1C of the Trade Practices Act and various parts of the Telecommunications Act.

The commission is requested to aim to improve the overall economic performance of the Australian economy in its considerations. A copy of our full terms of reference is available at the end of the room. I would like to reinforce a point that we have been making during the inquiry and that is that this inquiry is not just a stocktake of the "here and now" but is about setting the regulatory framework for the medium term future of telecommunications in Australia. I would like to express our thanks to those people and organisations who have contributed to the inquiry to this point, including those who have responded to our draft report. These hearings represent the next stage and will be a valuable input into the finalisation of our report. The final report will be provided to government by or before 22 September this year.

I would like these hearings to be conducted in a reasonably informal manner, but I remind participants that a full transcript is being taken and will be made available to all interested parties. It will be posted on our Web site within three days of each of the days of hearing. At the end of the scheduled hearings for each day I will provide an opportunity for any persons present to make a brief oral presentation, should they wish to do so. I would like to welcome to the hearings our first participants from Telstra. For the record please could you each state your name and the position that you hold.

MR AKHURST: Good morning and thank you, commissioner. I am Bruce Akhurst, group managing director, legal and regulatory. Accompanying me is Deena Shiff, Telstra's director of regulatory, and Paul Paterson, Telstra's group manager of competition.

PROF WOODS: Thank you, Mr Akhurst. Do you have an opening statement you wish to make?

MR AKHURST: Yes, we do. Telstra supports the commission's view that the industry-specific competition rules have outlived their usefulness. We agree that they harm investment and represent a handbrake on competition, which is ultimately against the interests of consumers. In particular we agree that the industry-specific competition rules need an overhaul. We support the commission's draft recommendations to repeal Part XIB of the act. In our view, Part XIB was only ever designed as a short-term transitional measure and was never intended to be a long-term substitute for competition law. It should be repealed. It is past its use-by date.

We think Part XIC should be aligned with Part IIIA of the act. We agree with the commission's draft recommendations to replace the declaration criteria with threshold criteria that reflect those in Part IIIA to create sunset provisions for declarations and to legislate pricing principles that recognise the importance of investment for long-term competitive growth and to encourage efficient investment. What we are describing here is replacing the infant industry rules with long-term competition regulation.

We are not talking about deregulation and we are not talking about infant competitors. In our last appearance before the Productivity Commission we noted that Telstra's main competitors included some of the biggest, toughest and richest companies in the world - Vodafone, a $400 billion plus company that dwarfs Telstra; Cable and Wireless being replaced by a government-backed virtual monopolist in Singtel as controller of Optus; TCNZ, AAPT, the dominant carrier in New Zealand, and others, which include Hutchison, a $100 billion plus company.

In terms of market success we can hardly go forward without noting the interim results announced last week by Optus, a primary competitor - 60 per cent lift in net profit, sales of almost $5 billion and 3.7 million customers, and that is about one-third of the number of Telstra's customers. Optus has certainly come of age, so let's not have any baby talk about the need for infant industry protection. Indeed, the cost of maintaining these infant industry laws is considerable. They have added only delay, uncertainty and discouraged investment, especially in regional and rural Australia.

They have encouraged Telstra's competitors to quarantine their investment to mainly commercial areas and wealthy suburbs. In short, these infant industry laws were right for the times, but times have changed. We also note that the commission is considering the state of the industry not just at the present but two to five years into the future. We fully agree with this approach. If competition is allowed to flourish this will be a period of enormous and exciting technological change for the whole industry. If competition is restrained investment will be skewed, technology choices will be biased, build or buy decisions will be distorted, and consumers will be worse off.

For instance, no-one can doubt that wireless solutions are already an effective substitute for fixed line telephony services. Likewise, in the not too distant future it can be expected that broadband wireless solutions will compete more vigorously with broadband fixed network delivery platforms, both copper and cable. Consumers can therefore expect a vast array of exciting service offerings to be available. Their expectations are likely to rise in direct proportion to the speed with which these technologies emerge.

This makes it critical that the regime be flexible enough to encourage, not discourage the roll-out of these technologies. In particular, below-cost access pricing

imposed by the regulator to promote short-term competition or placing regulatory bets on particular technologies inevitably discourages investment in new and better technologies, which long term provide the basis for consumer choice and competition.

The worst possible outcome for the industry and for consumers would be to be locked into old or dated technologies simply because there are no incentives for competitors to invest in anything new. You will hear it said during these hearings not only that Telstra's control of the copper network requires the continuation of access regulation - which we do not dispute - but that the regime should be bolstered so as to control Telstra's market power.

Those who are least inclined to invest or compete will no doubt be the noisiest in advocating greater powers for the ACCC. In part-time some have suggested in recent days that in view of the very considerable delays in reaching commercial agreements and regulated decisions the ACCC should have greater powers; even that the ACCC be given absolute power without merits review, as a way of speeding the process. These proposals treat the symptoms without addressing the cause.

First, Telstra is not the cause of these delays. Telstra is a victim of them. The ACCC literally takes years to make its determinations and, we believe, resists final determination specifically to avoid judicial scrutiny and public accountability. Blaming Telstra for the delay is akin to blaming a litigant for court delays or outstanding judgments. Second, if the problem is delay the ACCC should simply be required to get on with the job, make determinations and make them final. The ACCC should operate more effectively within the vast array of its existing powers.

Thirdly, Telstra is more than happy to participate in information sharing and multi-party hearings to speed the resolution of disputes. Notably, 90 per cent of our agreements are already settled commercially, but the current rules encourage some to pursue regulated outcomes however long it takes rather than negotiate. Fourthly, the ACCC consistently gets it wrong. Telstra believes the ACCC applies its arbitrary powers in a way that favours competitors rather than competition. It pursues token short-term benefits at the expense of the long-term consumer interest.

We believe that if the ACCC gets it wrong it should be overturned on appeal to the higher judicial authority, the Australian Competition Tribunal. Merits review is a key factor in reducing regulatory gaming and in providing regulatory accountability. At present access pricing uncertainties make arbitration an inevitability for those whose investment depends upon the regulatory swing factor. The inherent arbitrariness of this process and the lure of arbitration would be magnified many times over where merit review curtailed and access pricing left to the too-hard basket.

Fifthly, the more power that is given to the ACCC the greater will be the uncertainty in the industry. No investor would ever be confident of their investment

return or even the criteria on which the ACCC decided the value - its use of their asset. If the ACCC has absolute access pricing powers no investor would be confident of a return and no-one would invest. Investor certainty and confidence comes from developing workable approaches for industry undertakings, investment safe harbours and better models for access pricing.

It's important that the commission's report not be pre-empted or hijacked and that any legislative reform in this area be fully informed by your report. A selective and piecemeal approach to this reform process has the extraordinary potential of accelerating the damage to the industry by robbing consumers of the benefits of competitive investment. I will now ask Deena to make some comments.

MS SHIFF: Thank you. Let me now outline what we consider to be the central issues in this inquiry, many of which are already raised in the commission's draft report. There are a large number of issues that are given thoughtful consideration in the report, so we have tried to isolate those which we think are the sort of threads that can be pulled that will create the most benefit. Of greater significance to the long-term health of the industry at this stage in its development, we believe, is firstly how to improve the existing system by encouraging negotiated outcomes rather than regulated solutions and, secondly, how to provide more certainty in relation to investment.

Let me talk in more detail about Part XIC. There are two critical and related legislative policy issues at stake here that can drive the balance of incentives towards commercial negotiation and which play a critical part in determining forward investment. Firstly, access pricing. The first issue of significance is the broad discretion associated with the adjudication of access prices. Uncertainty is pushing parties towards dispute and making it possible for the ACCC to sit on and then reject whatever undertaking is placed before it.

Even within its chosen TSLRIC methodology, which is now not used in all cases, magnifying the uncertainty factor, vast swings in results can be achieved through choices in network optimisation, asset valuation, depreciation WAC and so on. We share the commission's concern about the uncertainty of access pricing arrangements under the current regime. We therefore welcome the clear statement by the commission that the costs of setting excessively low access prices are likely to be more insidious and have a more detrimental impact on economic welfare and consumer interest long term than the undoubted cost associated with setting access prices excessively high.

We'll provide additional details to the commission in our further submission to the inquiry as we are aware - and the commission is aware - these are complex issues. However we strongly support the notion of legislative criteria that aim to ensure the full recovery of efficiently incurred costs and we also strongly support a requirement that the regulators specify a floor and ceiling as part of its assessment of access prices. Without this area of reform many of the procedural measures

mentioned in the draft report aimed at speeding the dispute-resolution process are doomed to fail, but if this area is reformed the procedural reforms may prove unnecessary.

The second issue goes to investment safe harbour and the investment uncertainty associated with the present regime. The present regime has failed to provide the pre-eminence to undertakings that the Hilmer report intended for general competition policy as the means of avoiding detailed, intrusive and costly regulatory intervention. The failure of undertakings is related to the excessive discretion granted to the ACCC to determine the reasonableness of access prices. In the absence of predictable and transparent criteria it is also difficult for an investor to know whether or not to invest.

Digitisation of the HFC network is a case in point. Apart from the uncertainty already inherent in the access regime the ACCC has recently issued a threat to cable owners to either provide access or be regulated. Prof Fels recently stated, and I quote:

> Where the industry characteristics and structures prevent the effective operation of competition we believe that regulation will continue to be required. Similarly, our stance on digital cable services is one of allowing the incumbent operators to take the initiative to establish access arrangements which benefit themselves and potential access seekers, rather than to mandate access through regulation.

Telstra wants to generate and improve upon its suite of wholesale services and wants to offer access and avoid unnecessary regulatory intrusion but, in the absence of any certainty about either the scope or the duration of declaration, or the pricing principles to be applied, there is little incentive to go down that path. This uncertainty also feeds back into the undertaking process. We do not believe that access holidays that have been suggested by the Productivity Commission fully address these concerns. For example, in many industries, not just in telecommunications, industries with long asset lives, an access holiday is of limited importance in the early stages of the asset's life, which is generally when the holiday is proposed to apply, when total revenues fall below costs only to cut in when the blue sky comes.

As an alternative, we propose firstly that the regime should allow the regulator, prior to an investment being made, to issue a binding opinion as to whether or not the declaration criteria would be satisfied. Of course, this would be subject to a material change in circumstances proviso, but it provides some certainty in the decision-making process of investment about whether you're going to be regulated or you're not going to be regulated ex ante.

Thereafter, if this opinion were to indicate that the service would likely be regulated, then a number of alternatives should be considered. One option is the

regulator firm detail a number of the features of the investment. For example, total expenditure, anticipated asset lives, anticipated capacity available to access seekers in relation to its investment. The regulator would be required to have regard to this evidence in future access disputes, simply as presumptive of its facts, and would face a significant evidentiary burden if it planned to dispute or disregard these facts when setting regulatory access prices in the future.

We recognise that this option may not provide sufficient investment certainty, as it's not determinative of the outcomes, and we would welcome improved statutory provision form and a clearer set of criteria to govern pre and post-declaration undertakings. Much of this work for greater certainty can be done via pricing rules, but the process that undertakings must go through also needs to be reformed. Given the public and protracted nature of the processes adopted by the ACCC to adjudicate in this area, we see little scope for this machinery being used to deal with commercially-sensitive, competitive or greenfields investments, unless those processes are substantially streamlined and improved.

We have detailed proposals for regulatory contracts and undertakings in our submission. We believe, in particular, that unless this area and the area of access pricing is addressed, then part XIC will continue to fall short of expectations. We also believe that had Telstra been able to agree PSTN undertakings with the ACCC in 1997, or shortly thereafter when our undertaking was lodged, then most of the disputes that then ensued, that have clogged up the system, could have been avoided. We believe that the ACCC, not only in this sector of the economy but in other sectors of the economy, has proved itself unable to accept and encourage undertakings and that parliament should reassert that priority.

Turning to sunsets for declarations, we shared the commission's concerns about the lack of any specified use-by date for declarations under part XIC. We agree that the declarations should be sunsetted. We believe that this would serve to remedy the current situation where the ACCC has declared services for which alternative services are already declared and hence make regulated access prices unnecessary. As outlined in its submission, Telstra believes that declarations should last no longer than three years and that a declaration should be automatically revoked once the sunset period is reached, unless the regulator can demonstrate that the statutory conditions for declaration of the service continue to hold. We believe that services that are already declared can be grandfathered into this new regime, but should also pass a relevant or revoke test after a prescribed period.

Turning finally to part XIB, our views in relation to part XIB are relatively straightforward. We agree with the commission that part XIB has not been shown to be effective and that it greatly increases the chances of the ACCC getting things wrong. Of late, we believe that the general competition law provisions in part IV of the act are increasingly proving themselves to be effective at regulating market conduct in telecommunications or any other sector. The ACCC has, itself, highlighted the current effectiveness of section 46 of the act in regulating market

power. Since the first public hearings of this inquiry in August last year, the ACCC has issued no fewer than three press releases supporting the decisions of the courts in relation to the enforcement of section 46 of the act.

Each press release points to the strength of that provision in regulating market power. For example, immediately after the High Court's decision in Melway was handed down, Prof Fels issued a press release arguing that the decisions, that is the decisions in Boral, Rural Press and Melway, showed that the courts would protect the legitimate interests of small businesses, the competitive process and ultimately consumers from abusers of large and powerful market participants, in a variety of factual circumstances. This judgment and the other recent decisions in relation to the meaning and application of the misuse of market power provisions of the act have important applicants for the ACCC's trade practices enforcement program, and the ACCC will consider future complaints in light of these judgments.

It follows that the ACCC itself recognises the potency of the general competition law provisions in regulating the market power of large firms. In view of the increasing effectiveness of the general competition law provisions in the act, it's difficult to see how the ACCC or others could sustain an argument that part XIB is essential for regulating telecommunications, or even worse to argue that the provisions should be bolstered. We believe that part XIB, or any variant of it, is not adapted to dealing with the power imbalances associated with interconnection, and the disputes that are likely to arise in the future. These can continue to be managed under part XIC, even in a reformed state, and via self-regulatory processes.

Other than these observations we agree with the Productivity Commission's findings in relation to part XIC that coupling an effects test with the reversal of the onus of proof and the competition notice increases the likelihood of regulatory error and overreach, and we have not seen anything in either our competitor's submissions before the inquiry or in the material put to the commission by the ACCC, which appears to offer any evidence to the contrary. I will now hand back to Bruce Akhurst.

MR AKHURST: Thank you, Deena. As you've heard, Telstra believes that fierce competition, in combination with general sections of the Trade Practices Act, together provide the most effective controls on anticompetitive behaviour. The additional infant industry regulations have added only delay, uncertainty and discouraged investment. They have also encouraged commercial disputes rather than negotiation. In the months since we last appeared there has been some change in the ownership structure of this industry. What has not changed is the size and influence of our rivals. They continue to be large, international firms, in many cases with market capitalisation far higher than Telstra. Optus has just posted a record profit. They continue to enjoy economies of scope and scale and they continue to advocate a hardening of the regulatory arteries for their own commercial self-interest.

Telstra's position is also consistent. While we have always accepted the need

for competitive access regimes, it is overwhelmingly in the interests of consumers for the infant industry sections of the act to be repealed or redesigned, as was the intention when they were first introduced. Otherwise, why did we bother moving Australian telecommunications from a regulated monopoly to a competitive market? The monopoly Telecom was heavily regulated, always short of capital for investment in new services, consumer prices were high and service was poor. The competitive market has falling prices, improving service quality and should attract investment in new and better services. These consumer benefits, which came from dismantling the old Telecom monopoly, will only continue if there's a continuing wind-back in regulation that discourages investment and competition.

In our view, you can't have both the consumer benefits of a competitive market and the regulatory controls of a quasi monopoly. Moving from one system to the other requires the regulator to traverse a slippery slope. If we stop moving forwards towards a fully-competitive market, Australia will inevitably slip back to a controlled market with little investment, little innovation and ever narrowing consumer choice. Thank you. We would be happy to deal with any questions or other points you might like to raise with us.

PROF WOODS: Thank you, Mr Akhurst, and thank you, Ms Shiff, for those introductory comments. Albeit somewhat late, we have received your submission and have had the opportunity to read through it prior to these hearings. Thank you for ensuring it was in at least to allow that to occur. You've addressed a number of issues in your opening comments, which are also brought up in the submission, so we will deal with those as we go through your submission section by section. Can I say at the front though, that you make a substantial play about the level of competition and the size of competitors. I would draw your attention to a statement in our overview, in fact on the first page of our overview, that says:

> The commission argues that the focus of regulation should be on the core bottlenecks, as best exemplified by access to the local loop.

I would like to get back, as we go through this process of hearings, as to where there is competition and where there is not robust competition, and where regulation should therefore focus. I think we may get distracted if we characterise the industry generally as being competitive and with large players, and fail to focus on some areas where there seem to be persistent bottlenecks. In fact, in your opening comments you acknowledged bottlenecks in relation to local loop as an example. So if we keep the regulatory focus particularly on those areas we won't get distracted by broad characterisations that might lead us to other conclusions. In our earlier hearings, Ms Shiff, as I recall you outlined the process of accounting and operational separation of wholesale and retail in Telstra, and offered some time lines of progress and what were to be the expected outcomes from that. Could you give us an update as to where that process is at, please?

MR PATERSON: Yes, commissioner, I will take that question.

PROF WOODS: Thank you, Mr Paterson.

MR PATERSON: Telstra continues to move down the path of effective accounting separation and I think it's quasi structural separation in the way we operate. We've now separated out the parts of our business that face the customer. So the retail parts of our business and the network or wholesale parts of our business - although some wholesale part of our business also face the customer. So we've separated out those customer-facing parts of the business - - -

PROF WOODS: By "customers" are you meaning at the retail end, as distinct from customers who might be wholesale?

MR PATERSON: Both retail and wholesale. Both types of customers. So there is a separate customer-facing wholesale unit, there's retail-facing customer business units such as Telstra retail, Telstra Country Wide, et cetera - separated those out from the network part of the business, if you like; the part of the business that makes those investments and manages those assets. On top of that we're moving down a path of a transfer of costs between those types of businesses. On 1 July we will implement a process where we have a transfer of the cash costs between those sorts of businesses and also a transfer, in a more aggregated form, of the network costs of the business. So we're moving down that path as indicated.

PROF WOODS: Moving down the path, I think that was the sort of phrasing that I recall from the previous hearing as well. You mentioned 1 July as one milestone for having some transfers at cash cost level. Is there any way you can be more definitive for the benefit of the rest of the industry and for the benefit of ourselves in understanding where this industry is moving, of other milestones of significance in this process?

MR PATERSON: At the moment we haven't moved to a system of full internal transfer prices. In considering that option a number of practical difficulties have arisen and we've found that the best option at this point in time is to have a transfer of our direct cash costs, so the costs are incurred outside the business, if you like, and the transfer of our network costs on a more aggregated basis, rather than on a unitised service-specific basis. We face the option, going forward, as to whether we continue to address those network costs in that way or move down a path of more specific unitised costs for the network part of the business. I think that will depend on our practical experience in that regard over the next 12 months.

Important in this, of course, is the record-keeping rules, or what is now called the regulatory accounting framework, the RAF, the information that the ACCC now obtains on a six-monthly basis on our underlying costs, which details not only the costs broken down on a retail product basis but also costs broken down on a wholesale product basis as well. Say, for example, in those accounts there is a set of costs for PSTN originating and terminating access and there is a set of costs for

unconditional local loop. Now, they include not only O and M-type costs but network costs, capital costs and included in that a return on capital. That, we believe, provides a significant degree of transparency to the regulator as to what our underlying costs are in providing those services.

PROF SNAPE: There has been quite a deal of comment, and there was comment at the first round of hearings, from other participants that they had been hearing the story that there would be a separation - so it would be much more transparent - and they had been hearing that story for quite a while from Telstra. From what you're saying, it's not going to be transparent in any foreseeable future.

MR PATERSON: Not at all. I would suggest that we have, in fact, arrived at that point in time where there is a high degree of transparency concerning underlying costs through the regulatory accounting framework, the RAF, the information that is provided to the ACCC on a regular basis. So I think we're there in that sense.

PROF SNAPE: It will be interesting to see whether other people feel that you are in that situation, and that they can be confident that you would be dealing internally on a similar basis with the way that you would be dealing with people externally.

MR PATERSON: Of course, in considering that, there are a number of practical factors that need to be taken into account. Our first is the consideration of whether we provide the same services internally and externally, and in a number of cases we don't. For example, we don't provide ourselves internally, from our network area to our retail divisions, with an unconditioned local loop. We provide the retail area with end-to-end services, so there is that particular consideration to be taken into account when one thinks about providing services internally and externally and how prices might compare.

As well, of course, as the commission has recognised in its report there are issues of how those prices are structured and reasons why they might be structured differently internally and externally, particularly for declared services, where the structure of charges is essentially set by the ACCC, where determinations are made there which may not accord with the most effective way of sending signals internally, so a number of considerations there.

PROF WOODS: Your use of the ULL as an example, I think, is quite instructive because it would seem to me to reinforce the point that Telstra in one respect acts as an integrated vertical entity that provides the service right through to end customers and deals in a different manner with others who may expect to have a commercial relationship at the wholesale level. Until there is a greater degree of separation within Telstra, as I was expecting arising out of the last set of hearings, I'm not sure that when we discuss the various issues in this inquiry that I can reasonably comprehend whether you're talking about Telstra wholesale on some issues and Telstra retail and the others, and perhaps as we go through the questions it would be very useful for you to indicate which of those two perspectives you are answering on

behalf of.

MR PATERSON: Yes. If you would allow could I just make a comment on your point there. I mean, there is very clear technical efficiency reasons why it doesn't necessarily make sense to provide the same services internally and externally and we could certainly provide detail on that if that was useful to the commission.

PROF WOODS: I think I comprehend some of them, but the principle I was trying to explore.

MR PATERSON: Okay.

PROF SNAPE: Just a comment that this is an area in which there has been considerable suspicion and criticism of other parties, not just the regulator, and I would have thought it was within Telstra's own interest to be more transparent in this regard than it has been because, unless it is, it is going to continue to be a running sore with Telstra, the fear that there is not equal treatment or there is not treatment which might in fact be justified by the various factors to which you correctly draw attention, but it is in fact just - well, some people would call it - "a strategy". I am just surprised that Telstra is not being more forthcoming on this issue and the transparency of its processes here by pushing this along very rapidly and in a very public and up-front manner. I wonder if you would like to comment on that?

MR PATERSON: Deputy chairman, I make a couple of points. The first is that I would refer back to the regulatory accounting framework and the transparency that that affords the ACCC. We have really moved into very different territory with the implementation of the regulatory accounting framework in that there is now great clarity as to the underlying costs on a specific product basis, including, as I have said, for the products that we provide other service providers - so the wholesale products such as PSTN - interconnect, so there is certainly that degree of transparency and there is, I think, absolutely no doubt that that exists in place and I am sure the ACCC would be more than happy to show you that particular construct that is in place.

Secondly, in terms of a move to arrangements that might fully reflect a wholly-embraced internal transfer pricing arrangement - and there are implementation issues there. As we have looked at that we have come across some fairly severe and challenging issues which have resulted in us taking the particular approach that I outlined a little while ago. That, to our view, was the most effective way to proceed in that regard.

Some examples of the problems one faces in structuring that come back to the sorts of services that are provided internally and externally and how we handle that particular issue, and what sort of reconciliation with internal-external prices might be gone through under that sort of structure and, for that and other reasons we have opted for the particular approach we have taken, of certainly transferring our cash

costs internally in a very explicit manner because they are very clear and doing the network costs in a more aggregated way.

PROF WOODS: We are fully conversant with our terms of reference which require that we not encompass the structural separation of Telstra in line with government policy on this issue but, had there been a government with a mind that gave Telstra six months to turn itself into two companies, I am sure those responsible would have risen to the challenge and have created two companies and have resolved many of these clearly difficult and complex matters that you refer to.

MR PATERSON: Indeed, in taking that choice the government would be making the explicit decision that it considered any benefits of structural separation were more important than the benefits that come from integration and economies of scope and economies of scale, perhaps, from the integrated model we have got and, yes, if required, those issues could be addressed and resolved in a way. We believe in the interests of end users and the interests of minimising costs and being able to provide services to end users at the lowest price possible, it is important to draw on the economies that come from being an integrated service provider.

PROF WOODS: I guess my point was more on the timeliness with which you're resolving some of these complex matters of accounting separation.

PROF SNAPE: What you have just outlined does seem to be a very defensive sort of attitude, reactionary, rather than getting on the front foot and countering by transparency these criticisms that have been levied by many parties - now you're saying you provided to the regulator and yet you're trying to get the regulator off your back. Wouldn't it be better to be more transparent in an open manner beyond the regulator than just satisfying the regulator?

MR PATERSON: Yes, I certainly see the merit in the point being made and would agree that there are clear benefits in terms of the regulatory environment, including the regulatory environment that Telstra faces of maximum transparency in that regard. It is a matter of practical implementation. It is a matter of resourcing of these things. As I said, we're at a particular milestone come 1 July this year, which are moves to go forward significantly and scope for further implementation as we go forward.

PROF SNAPE: We got the impression last August that it was something to which you attached a high priority, but it would appear that if it hasn't been resourced to bring it about more quickly; that it hasn't been accorded such priority.

MR PATERSON: With respect, I would beg to differ. We have certainly had the best and brightest people in the company focused on the particular issues there and believe we've come a long way forward in terms of what we'll have in place on 1 July.

PROF WOODS: Perhaps when you provide your further submission if you could elaborate on these points that would be helpful to us and, of course, that submission will then be put on our Web site and made available to all interested parties. In your submission the overview - we'll pick up the points as we go through, and then you have a section, Approach to Telecommunication Regulation. I think particularly I want to focus, but somewhat later in our session, on your comment about "incentives for facilities-based local loop competition" and I think it might be best brought out when we talk about pay TV, which you usefully address in section 7 of your submission, so perhaps we could pick that up in that context particularly.

Section 3 then deals with increasing regulatory certainty and seems to be a commonality of view between the commission and Telstra that the greater the certainty that can be achieved, the better for industry generally to make business decisions that will ultimately lead to good product and appropriate pricing for end users. Safe harbours - you've looked at our draft report which deals with the issue of how to increase certainty in terms of prospective investment.

You make an excellent point on page 25, which refers to the vast bulk of investments in regulated assets, relate to the maintenance upgrading and augmentation of existing facilities, so if we can keep that comment in mind as we come back to your safe harbours comment, and I guess my first question then is, how important is this need for ex ante regulatory certainty in relation to new investment and what sorts of investment we talk about. You mention the digitisation of the HFC as one example, but perhaps whoever can extract it - - -

MR AKHURST: I think it's crucial. One of the difficult things is that there is no kind of score card kept of these things. Business proposals come forward and they're knocked back because of - - -

PROF WOODS: Knocked back within the organisation?

MR AKHURST: Within the organisation, because they're too risky or the pay-off is not going to be there, and the digitisation of the cable is a good example. That has been shelved for the reason that Telstra and its partners in pay TV cannot see a certain enough outcome at this point to spend the millions of dollars that that will require.

PROF WOODS: So in effect, looking at it from the end consumer's point of view they are being denied - - -

MR AKHURST: Exactly.

PROF WOODS: - - - that facility because Telstra is not proceeding with that investment because it claims there is uncertainty about what the access rules will be. Is that the line of logic?

MR AKHURST: That's right. I mean, we'll go along and we'll talk to the ACCC and say, "We'd actually like to digitise the network and bring in digital TV services, and our partners would like to do that, and there are models of this happening all around the world and our partners have a lot of experience in doing that - in Britain, for example, with B Sky B in the case of news." Then we go to speak to the commission about it and they point out, quite correctly, that they don't have any regulatory power, if you like, to make any decisions or give any commitments before the money being spent and applications being made subsequent to that, so you are very much left feeling, "Well, what's the track record on declaration? What's the track record on access pricing? How might that apply here?" and there is a great deal of discomfort about it, particularly when it's a new technology. There will be a lot of trialing with customers and getting customers interested in it and a lot of investment to make that happen over a longer period of time. Any additional layers of uncertainty on the whole thing can really slow it down. That is effectively what has happened.

PROF SNAPE: So if you could be sure that it was not going to be declared you would go right ahead with it now?

MR AKHURST: We would spend a lot more time seriously thinking about it and doing a digital media plan and all those sorts of things and coming forward with the business case but, at the moment, you just don't really know what numbers to plug into the model.

PROF SNAPE: But this is not exactly uncharted territory. I mean, in other countries digitisation has gone ahead and so it is not as if you are putting your foot in water that no-one has put their foot into.

MR AKHURST: Well, that is how we're assessing it: that the price you'll be able to sell those services for - the return you'll get for that underlying investment - is basically uncertain.

PROF SNAPE: You're arguing that it is the uncertainty with the ACCC that is holding you back even looking at it?

MR AKHURST: That is one significant element to it. There is no question about that.

PROF WOODS: It would certainly be useful to us if you could out the range of uncertainties. One of them must be customer uptake.

MR AKHURST: That's right.

PROF WOODS: One of them must be competitive - - -

MR AKHURST: Responses.

PROF WOODS: Yes, and some of it is regulatory - - -

MR AKHURST: Technology uncertainties. There's a whole range of things that go into it.

PROF WOODS: So we need to put the regulatory uncertainty in context, and I don't have a clear understanding of that context from the answer given at the moment. Miss Shiff, were you wanting to elaborate?

MS SHIFF: In the context of the digital?

PROF WOODS: Yes, as the first example. I mean, we can explore others.

MS SHIFF: It's hard to put a weight on the regulatory uncertainty relative to other factors. You make a qualitative judgment that that's the straw that is breaking the camel's back, but it is just paradoxical in circumstances where you plan for an open network with wholesale services, and we should be encouraged to do so, and yet you can't be led down that path unless there is some legitimacy conferred on that at the time you are planning investment.

If it is something where it is totally uncertain and you don't know whether the nature of the scope of the wholesale services or the price of the channels is going to ultimately prove acceptable and you're looking at years and years of dispute, it becomes very unattractive. That's the simple point we're making. It also plays itself out in relation to - I mean, most of our investment is augmentation rather than Greenfields. This problem is most acute with Greenfields, where you just have to assess all the risks and it is a red light or it's a green light.

With augmentation you may - I think what is insidiously happening is that you scale back from areas where you know the dollars aren't going to fall into a regulated asset base and they'll just get lost and there is a strong tendency to want to put those dollars elsewhere where you will get a higher return. Again that seems to us to be sending poor signals in circumstances where the government wants to improve service quality in the access network. I mean, this is necessary new investigation, even though it is existing infrastructure, and there should be some regulatory compact where you can discuss and green-light the level of outlay that is going forward and have some understanding of how it will get reflected in the asset base going forward.

PROF WOODS: But let's stick with digitisation just for a moment and we can deal with augmentation soon. When we looked at the range of uncertainties - and they included customer uptake and price points that they were willing to pay compared to alternative entertainments and the like. We look at technological uncertainty. We look at behaviour of competitors. Now, there is experience on those issues in other countries.

MR AKHURST: There is.

PROF WOODS: You have to do the translation process and look at the Australian market and understand all of that - and we do lots of benchmarking in other areas, so we do understand some of those issues but, nonetheless, there is a guidance that is available.

MR AKHURST: Yes.

PROF WOODS: If you were the provider of the wholesale facility - you owned a cable and you thought, "If we digitised it there is a market there at the end point for the services that could be transmitted through that cable," I would have thought that on all of those business cases there would be some certainty with which you could plan. So to go back to where we were earlier, if you were answering this from the wholesale perspective, I would have thought the question of who the service providers are who pay is a lesser concern because you know through your other business case issues of customer uptake and technological issues and the like that you can construct with some certainty what the outcome would be, so the wholesale decision-making in Telstra - digitisation - I don't understand why it is such a concern. At the retail end I could understand that the retail part of Telstra might have issues about who else might have access and therefore who wins the customer's heart and mind, but aren't they two different issues?

MR AKHURST: They are two different issues. Overall from Telstra's point of view we would like to drive traffic and revenue across our pipes, in very simple terms, but if that activity is not covering the cost then it is not worth doing.

PROF WOODS: I understand that.

MR AKHURST: That is fundamentally what we're concerned about - that we'll put all the money down and the investment in place and a lot of it will be based upon what we think we can sell that capacity for. We'll be able to know, presumably, with Foxtel what they're willing to pay for that capacity - what we'll get out of that investment from them. What we don't know is whether the ACCC is going to price the underlying service at a much lower rate that doesn't cover those costs and undermines the price we'd get from Foxtel, as well. That's our major concern.

Yes, we can definitely look at uptake statistics in the UK and in the US and we've done that, and the different range of services, and we have got technology experts in the company that know about digitising things and set-top units and all of that. All those are uncertain but we can draw some reasonable conclusions about that. What we really don't know, what we're not confident about - and particularly I should say after our experience on the analog side with the ACCC that we would get an economic return on the investment, and we say we haven't with the ACCC's decision's on analog and us and our partners are not confident that we would on the digital side and we're not able to get clear decisions from the ACCC under the

existing regime.

PROF WOODS: I guess the "us and our partners" is the retail end more so than the wholesale end though, isn't it?

MR AKHURST: That's right. Absolutely the retail end.

PROF WOODS: That's why I am trying to keep a distinction in your answers between what is your wholesale perspective of this issue in relation to facilities competition versus what is your retail perspective in terms of service competition.

MR AKHURST: From our retail end, though, the concern is, what is the input cost they are going to face in launching a service, and then whether the - their competitors went to the market at a much lower input price, so it does have a very significant connection with what the retail return will be.

MS SHIFF: If we ran this solely as a wholesale business and as the common carrier you would still face the problem of recovering the capital costs and the direct costs associated with the digitisation.

MR AKHURST: Yes.

PROF WOODS: But in some sense there are different perspectives and issues between the wholesale and the retail.

MR AKHURST: There are definitely.

PROF SNAPE: I was just going to pick this point up about the maintenance and you say that a great deal of your investment is maintenance upgrade and augmentation of existing facilities, and you have made the point at earlier times that some of this is upgrading what you regard as a deficient copper wire network, yet you are not going the path of having telecommunications, or at least telephones, going through the HFC cable. You are saying on the one hand that the copper is worn out in many parts or it is no good in many parts. Why not get rid of it? Why not in fact use, as Optus does, the HFC cable for telecommunications.

MR AKHURST: I'm not an expert but my understanding is that the cables are different types of cables.

MS SHIFF: I'm not sure about the product of the voice quality down the HFC, but what we're certainly doing is looking at bypass technologies where they can be substituted for the copper network over time and, like other people - and there is quite a lot of spectrum in the pipeline that I think goes beyond what is in your market survey that can be used very effectively for wireless local loop. Just ex hypothesis a district by way of example; say in areas where our costs are very high we want to explore a joint investment structure in regional Australia to replace the copper

network with a wireless local loop, we and our co-investors would want to know what the access treatment would be.

We would be happy to provide access. They just want to know when they put their money on the table. It's like any other infrastructure investment in Australia at the moment, which all suffer from similar issues. I think the regulatory process should encourage us to get out there and innovate and do those things and feel confident about what the future holds, but what is lacking is a mechanism to do that. There is no ex ante mechanism in the act, unlike Part IIIA, where you can either put the facts forward or get some sort of confidence or some sort of contract together or some undertaking together that pins down the sort of relevant financial assumptions and encourages us not only to invest but to provide access early.

PROF SNAPE: I am trying to think of drivers of broadband here and voice, of course, can be a driver. If you're combining voice with a broadband cable, as Optus' plan is, then that would seem to me a driver of broadband. I'm trying to think of a - - -

MR AKHURST: A package.

PROF SNAPE: - - - package. I'm trying to think of a future with some vision in it that is getting broadband. We have been criticised in this draft report for not having enough vision in it, and I am trying to get a bit of vision. Vision here is broadband going out and ways of driving it. Now, one way of course would be to give up your copper cable where it is in fact inadequate. You're saying a great deal of your investment is in maintaining that and yet you do not take - with Telstra - your voice over the HFC. Your competitor is doing so. Why have this barrier? I understand it is an agreement between the companies that you have got this barrier - - -

MS SHIFF: To be honest, I think the HFC, just our HFC, wasn't designed to carry voice. It was designed to carry pay TV signals - we need an engineer to explain that in more detail. In contrast, in New Zealand we're doing a Siamese-twin operation, where we're twisting the copper around the fibre and the coax into the home and we are putting them all down as one package in our consortium in New Zealand with Austar. So given a kind of Greenfields opportunity, that is how we are doing it at the moment and in fact we are dramatically transforming in the areas we have rolled out the local assess network by duplicating it.

PROF SNAPE: But you're not adopting that strategy in Australia, even in Greenfields areas in Australia?

MS SHIFF: We have put our HFC in without planning it for voice because the supposition at that time - this was pre the ex-DSL days and the supposition was, copper is for voice and the HFC would be for pay TV. Had we wound back the clock and done it again we might have reconfigured it somewhat differently but, nevertheless, there are other opportunities out there to provide broadband and voice

through other technologies, like wireless technologies, and we are very actively exploring those.

PROF WOODS: Let's look at augmentation. We have some large land developers in Australia on the fringes of our major cities. What approach is Telstra taking in terms of working with them for wiring up new suburban developments, including small business and the like and, if we can then pursue that further, what approach is Telstra retail taking when others are indicating that they may wish to put in the facilities at the wholesale level and sell those to whoever, including Telstra, for telephony or other services? If we can just pursue that issue. What is Telstra's approach?

MR AKHURST: In new estates, as I understand it, the network is installed at the time the estate is built, if you like, so there are a lot of examples of the wires being laid at the time the estate is being built.

PROF WOODS: But are there any indications from developers that they're interested in putting in or owning the facility and that Telstra and others make use of it? I mean, is that a model that is developing in Australia?

MR AKHURST: I haven't heard of that.

MS SHIFF: I haven't heard of that but it's certainly spoken about a lot, not on a sort of property development context but it is spoken about a lot in terms of stimulating investment in regional Australia. That the best time to go in and put in new network is when other regional development activities are taking place, like they're putting in a road or they're redoing the power supply of electricity. It's the sort of natural habitat for new investment models to take root, and although I'm not aware of it yet taking place, it seems to me, and seems I think to Doug Campbell and TCW, to be something on his radar screen as something worth exploring. The extent of investment in new developments, although I don't have the data with me, was broken up in our (indistinct) submissions, so I can - - -

PROF WOODS: No, we've got a copy of those.

MR PATERSON: If I could come in there: for new developments, or for laying out any sort of a network that involves underground cabling, a significant part of the cost is the actual trenching and ducting that is involved. Of course, in a new development there's complete scope to share those ducts and trenches, and in fact the developers themselves usually pay for the ducts and trenches; the laying of the cables themselves, the cost of the cable is in fact only a small part of the cost. The economies are there in terms of the shared ducting and trenching.

PROF WOODS: What is Telstra retail's approach when another company indicates its intention to provide, say, a cable broadband capacity in an area and Telstra itself may still only have basic copper services? Does Telstra retail look at that and say,

"Well, that's good. We don't need to get our wholesalers to go in and put in upgraded facilities for this purpose. We can buy time and space on someone else's cable network"? Transact might come to mind as an example of somebody who is putting in cable in an area which is, as I understand it, of much greater capacity than your existing copper. Would that cause you at some stage, as Telstra retail, to say, "That's good, that's a terrific service and we'll be inclined to - - -"

MS SHIFF: My understanding is that we are open to, and have recently been approached by, some pretty innovative propositions by people who are putting in alternative cans, which we're actively looking at, because they realise that we have capacity constraints in certain areas. So we are actively looking for opportunities, if somebody can do it cheaper than we can do, to leverage off that. Telstra retail is pretty active in not wanting to be committed to Telstra wholesale's cost structures if somebody else has got a better one.

PROF WOODS: Presumably in the interests of pro-competitive modelling, that you wouldn't want to do it on an exclusive basis, you would just be one of those using it on an open-access model.

MR PATERSON: Yes.

MS SHIFF: Yes.

PROF SNAPE: Does this apply also where it might - you're coming back to the maintenance and replacement question again?

MR AKHURST: Yes.

PROF SNAPE: Where you in fact - - -

MS SHIFF: If you have very high faults, and the faults are often associated with constraints on capacity in any event.

PROF SNAPE: Yes, but in those areas would you in fact be prepared to give up your copper wire, to be using someone else's cable?

MR AKHURST: Yes.

MS SHIFF: Yes, in theory we would.

PROF SNAPE: In theory?

MS SHIFF: Yes. Well, I mean, I say "in theory" because we have to provide a standard telephone service, so whatever the other person has on offer has to fit the purposes of that obligation including the ability to offer preselection. Now, you might argue that that should be forfeited in the interests of economising on the

capacity across the board, but at the moment we have a check list that we have to tick off in order to see it as a bypass opportunity for ourselves.

PROF WOODS: We can discuss later you are a significant shareholder in Foxtel, you raise pay TV here and we can discuss questions of exclusivity and pro-competition in that context a bit later in these hearings, but I think we will come back to the same principles. Are there safe-harbour examples? We've talked about digitisation, we've talked about bypass, local loops, augmentation. Any others that you would want to raise?

MS SHIFF: There are circumstances where the life of a project, say USO contestability pilot is two years, requires that everybody involved in the project has certainty up-front about how the interconnection charges are going to correlate with the USO subsidies, and everybody knows that in the context of USO pilots it has become a bit of an issue. That's on a significant issue in terms of the scale of the investment involved in those areas, but it's a significant issue in just highlighting that undertaking processes should be available in a way that is tailored to the time frame within which the decisions are needed.

So what you don't want to have is to go into - what you want to avoid is a situation where everybody who goes into a contestability pilot area thinks that they might end up in a two-year arbitration. The whole undertaking process was meant to obviate that. That means that the undertaking process can't take two years either. It should be that the scale of the consultation and consideration needs to be concertinaed to deal with the practicalities of the situation that is being adjudicated upon, and that is lacking from the current system. I mean, we can debate why the PSTN took three years as an undertaking, but there are other isolated projects where you would love to put in an undertaking. Everybody can have certainty. Everybody knows that they're not going to face dispute and risk going forward, but there just isn't an expedited process for dealing with these things.

PROF WOODS: And we'll look at undertaking specifically in a minute. With your safe harbours proposition, it's a question of what level of certainty a regulator can commit to over an extensive period of time. If you take out all risk, one wonders why it's actually a business being run. But nonetheless how do you resolve the tension between creating some regulatory certainty for a period that is foreseeable and where you can put forward evidentiary detail, and yet allow the regulator some opportunity in changed circumstances to vary the form of decision-making. I mean, you talk about a strict material change in circumstance clause. Is that the best we can do?

MR AKHURST: I think your suggestions about access-pricing criteria being a lot more certain greatly assist in this area, quite frankly.

PROF WOODS: So you're saying we can build up a raft of improved certainty so that each builds on the other?

MR AKHURST: Yes.

MS SHIFF: Yes.

PROF WOODS: So you've got clearer determination criteria, you've got declaration criteria, you've got clear-pricing principles, you've got sunset periods. So progressively you can weave a certain web?

MR AKHURST: A lot more specific, yes.

MS SHIFF: Yes, I agree.

PROF WOODS: I notice that you, in promoting the benefits of ex ante uncertainty, are saying it has the advantage of being presumptive of the facts contained in notification and avoiding substantial delay and public disclosure of the commercially-sensitive information. Which of those two has priority in Telstra's view?

MS SHIFF: Sorry, do you mean the confidentiality or the - - -

PROF WOODS: Yes, you talk about substantial delay and public disclosure, avoiding both. I'm just wondering do they have equal priority?

MS SHIFF: It varies case to case. A highly innovative, competitive new investment would, by definition, not be a very good candidate for an undertaking's process, which requires some exposure of the evidence and some adjudication. That's why the evidentiary note is particularly suited to those cases, because it's not an adjudication and hence doesn't give rise to public scrutiny, but at least it gives you a degree of confidence that the historical evidence that informed that investment decision will be called upon, which it tends not to happen at the moment. Once the investment is made the regulator has no risk in how it regulates in relation to that investment. So it's sort of a reminder of what informed that initial decision and it gives some comfort to the investors. It's not enough if you want to have a high level of certainty about the outcome, in which case you would need to go into a regulatory contract or an undertaking process.

PROF SNAPE: ACCC at the moment uses a scorch node basis for pricing, whereas, of course, in this evidentiary note that you're talking about you would be using the actual investment and your actual costs, which may or may not be best technology. So there's then tension there between what you would be putting forward as the actual investment and the basis on which the ACCC would be making its costs. Would you like to comment on that?

MS SHIFF: Yes.

MR PATERSON: Yes, we believe in the current environment, and the environment going forward where we now have robust competition, that in fact optimised costs and actual costs have very much come together. Looking back, there might be a case to be made that in years gone by when the copper network was laid down, for example, there weren't competitive pressures and one could argue there might have been a degree of gold plating in the network. Under current circumstances, where there is robust actual latent competition, we really believe that optimised costs are what we would actually be going for in any sort of investment proposal.

PROF SNAPE: Just on that gold plating, I seem to recall an argument at an earlier stage that in fact the copper network got underplated rather than gold plated, because there was some degree of labour capital substitution there. Was it gold plated or underplated? I mean, you, I think, were arguing once before that there was a lot of labour around and that in fact you could shift towards expecting more maintenance than was optimal, because you had that labour hanging around. So that's the opposite of gold plating. Was it gold plated or was it underplated?

MR PATERSON: Deputy chairman, I think the key point here is the imperative for efficient investment and optimised investment, the point being that the stronger the competitive forces the greater the imperative for optimised investment. That is investment that delivers a certain service and service quality at the lowest price. The point is that in points in time in the past when those competitive pressures weren't there, it might be argued that same imperative for optimised engineering is not there. At this point in time we believe it most certainly is there, and that is the critical point.

MS SHIFF: I think, just to go back to the original proposition, the safe-harbour provisions do need to be thought through in a detailed way, relative to the access pricing rules that are ultimately adopted, because that's where they sort of resonate and gain traction, and that if you were to run this proposal against the current rules we would still argue that there is a requirement to look at the legitimate business interests of the access provider, and you can't solely look at an optimised hypothetical network; it's a balancing act. Today, the balancing act isn't performed, they just look at a hypothetical model. So this could still prove useful, absent the rule change.

However, the preferred situation is that it sits alongside rule changes, so that you know what the relevant considerations are in relation to the access pricing and it can feed off financial information that can be provided by an access provider that's relevant to them, and there is some predictability and standardisation around the treatment of assets - their assets lives' depreciation and so on - across the board, so you know how those things will get factored in. It's not done ex post facto, resulting in quite unpredictable outcomes.

PROF WOODS: I think that concludes our questions mainly on that particular issue. Being 11 o'clock and before we launch into anticompetitive conduct and XIB,

perhaps if we take a five-minute break and allow people to have a quick cup of coffee and resume.

PROF WOODS: We'll continue with proceedings. We are receiving evidence from Telstra in the persons of Mr Akhurst, Miss Shiff and Mr Paterson, thank you very much. If we can move on to the commission's proposed repeal of Part XIB of the TPA. You have outlined your support for such a proposal. You have then developed some arguments and if I can pursue some of those: you make a fairly strong play about the importance of strong, pro-competitive conduct. Within Telstra when you're examining a particular corporate strategy, what sorts of criteria do you use to distinguish whether such a strategy or behaviour would be strongly competitive to the advantage of Telstra versus anticompetitive, in terms of doing harm to a competitor that might file, for instance, a section 46? What criteria and what process does Telstra go through to make that distinction, and is there a distinction?

MS SHIFF: Between anticompetitive and - - -

PROF WOODS: Between anticompetitive behaviour on the part of Telstra versus strong competitive behaviour to the advantage of Telstra.

MS SHIFF: Our marketing and pricing - - -

PROF WOODS: Can I just remind people that these microphones are only for recording purposes and so therefore they don't serve any amplification function.

MS SHIFF: Obviously our retail business units devise the prices and the product sets and the marketing strategies that they want to employ and their focus necessarily is on winning customers, really. It's on customers and on gaining their confidence and providing services that are appealing to them. Because there is a lot of regrettably, sort of, legal interplay in this industry. There is a lot of compliance work that's done on every product initiative or pricing initiative, which is basically traditional trade practices compliance analysis, and my suggestion is that whether or not Part XIB is there that compliance would still take place because in an industry that is as sort of competitive and as sort of well-heeled, your competitive moves are watched to see if they breach section 52 or section 53 or section 46 every minute of the day; and we watch our competitors, too, to see that there aren't any sharp practices.

It would be my suggestion that it is possible to distinguish pro-competitive from anticompetitive conduct and certainly we have in our legal capacity ruled out certain activities that we thought would operate anticompetitively. We do extensive imputation analysis to look at whether our wholesale customers can compete with us in relation to a retail pricing initiative and that analysis would have to continue as a

result of section 46. Having said that, the history of Part XIB, particularly in its early days, has meant that there were certain complaints that were I think calculated to freeze our marketing people in the headlights and to stop certain price reductions, especially around the more competitive STD-type services. I think that's an unfortunate ancillary to having the ACCC there with a sort of an open slather capacity to issue competition notices under Part XIB, and we've detailed case by case in earlier submissions, and I don't want to take you through it all again - - -

PROF WOODS: No.

MS SHIFF: - - - how that is operated in respect of each individual complaint that has come our way. I should add, although it is probably a bit gratuitous that, at the end of the day, Telstra is not the only player in this industry with market power - and my experience of late is that the complaints are not necessarily being generated towards Telstra but against other players in the market, including some who are most vociferous in arguing for the retention of Part XIB but, even having said that, I don't think that Part XIB has proved productive in terms of our ability to sell issues against those players exercising market power nor do I think it has proved useful in generating constructive solutions in respect of what are considered to be issues that we've generated.

I would add to that that when it was first designed, Part XIB was largely motivated by a fear that we would predate new entrants who are struggling to come into the market, and it is in that context that we've offered the fresh arguments in relation to what is happening with predatory pricing in cases like Boral - that the case law is moving in that area and, if anything, section 46 - it's easier to prove predation now than it was at the time this legislation was put in place.

PROF WOODS: Are you able to give specific examples of pro-competitive conduct that Telstra wished to engage in that has been frustrated by XIB sitting on the books? We know what has been brought up as actions in relation to XIB, but if we can go and look the other way, what activity is Telstra frustrated in not doing that it asserts is pro-competitive that XIB prevents?

MR AKHURST: My observation of it is that it's redundant more than adding anything in particular. The cases where it has been used have been inappropriate and the force that, if you like, is controlling Telstra's behaviour is one of complying with the law, being, "We will not engage in anticompetitive practices." I don't know that it adds anything terribly much more to what you get from section 46 and the other provisions other than very horrendous powers given to the ACCC and substantial fines. It is more redundant and useless than worth having and in the cases where it has been used it has been overbearing and inappropriate.

PROF SNAPE: If it is redundancy and useless that means that what you just referred to as "horrendous fines" doesn't really add anything.

MR AKHURST: It's when it's used that it's a problem. If you're asking the question about how it changes Telstra's behaviour or what Telstra does differently, nothing, because we comply with the law and the law comes from section 46, section 52 and so on. Our real concern is that when those particular provisions in Part XIB are used, the consequences are quite inappropriate and they're not the things that are driving you.

PROF SNAPE: So you don't agree with what we said in the draft report - that the reversal of the onus of proof and the horrendous fines are of consequence?

MR AKHURST: We do. We very much do.

PROF SNAPE: But you just said that you didn't alter your behaviour.

MR AKHURST: Our behaviour is to comply with the law.

PROF SNAPE: I understand that but there are always areas of certainty as to whether it is complying with the law or not, and they're the cases at which one looks - and what are the penalties? Yes, I try to comply with the laws and even the road laws but, if I was going to be shot if I did 61 kilometres rather than 60, I would be a lot more careful about sticking to 60.

MR AKHURST: Yes, that's a good point.

PROF SNAPE: If you accept that, then XIB is not redundant.

MR AKHURST: Yes.

PROF SNAPE: So it's not redundant?

MS SHIFF: I think what has happened in the industry is that there was a spate of XIB complaints and actions culminating in commercial churn and Internet peering. That did not result in a successful court action by the ACCC. Our sense is that, notwithstanding the fact that the ACCC has very wide powers, since the 99 amendments it has been more cautious in exercising them and has led to a sort of stabilisation where we are trying to focus very much on allowing our competitive activities to continue, disciplined by traditional competition law principles. Having said that, it is a horrible thing to have on the statute book because, at any point where somebody wants to game it and raise mayhem with complaints under this section, it exposes us to tremendous fines and sort of guilty-until-proven-innocent-type arrangements and that does in some circumstances condition our behaviour.

MR AKHURST: But there haven't been XIB instances for some time now.

PROF WOODS: We understand actions that have been brought up, but it is what effect - and, Miss Shiff, you just used the phrase "that does in some circumstances

condition our behaviour". To the extent that it does, some would argue therefore that the section remains relevant.

MS SHIFF: I don't want to put words in the mouth of the ACCC, but I think there is an acceptance that it is a very blunt instrument for dealing with a problem that arises. For example, we recently had a problem with Optus and Vodafone, who were, we thought, exercising market power by not allowing our city, our main network - our customers - to send SMS messages to their networks and they refused to put, we thought unfairly, protocols in place to augment the quality of our network and held that over us and over our customers.

Did we think XIB was a good way to deal with this? Well, it was an option, but I think now that we have more mature commercial relationships and self-regulatory processes, there are other avenues to deal with those problems. So the tendency is to be aware that nuclear war can break out with Part XIB but to try and use these other processes which are more flexible and better adapted to find a solution rather than to set you down the path of a rather costly and, possibly ultimately futile, set of legal actions. I think that is the sentiment of the industry and its regulators, and I applaud it. I think that is where the industry should be going in finding solutions to these issues that are adapted to the nature of the issues and not declaring nuclear war.

PROF SNAPE: But the fact that the nuclear deterrent is available may in fact mean that people are more reasonable than otherwise.

MS SHIFF: You know, the problem is, is that the sort of deterrent that you want to have there, or do you want to have a deterrent there that is actually capable of being implemented in a constructive and appropriate way?

PROF WOODS: You will have read the various submissions - - -

MS SHIFF: There are other ways of conditioning conduct than having this sort of redundant provision in place.

PROF WOODS: You will have read the various submissions from other parties, to the extent that they're being made available, who have taken strong exception to the proposal to repeal XIB. Now, in coming to our judgment on this issue, it's in part a matter of giving weight to evidence that says sections 46, 52, et cetera, in themselves determine behaviour as to what constitutes strong, competitive conduct versus anticompetitive conduct, against evidence that says the existence of XIB, its fines and its turning around of evidentiary provisions conditions behaviour. Now, we've got some sort of judgment as to what weight we give to those two different parts of the evidence, and if you could sum up your view on that, that would be very helpful.

MR AKHURST: My feeling of it is that if you're the only one that's going to get fined for travelling at 61 kilometres an hour, then the other motorists mightn't be too

fussed about that. So I think there's a degree of self-interest in putting that view forward. But if you're asking me about what is driving Telstra's behaviour every day we go to work, it's not XIB. It's much more about the substance of not acting anticompetitively when it comes to that particular issue and thinking, "There will be consequences if you were to do that," but we have a very strong culture and compliance mentality and systems in place to make sure that we don't act anticompetitively. I really don't see these days, let me put it in those terms, that XIB is pushing us terribly much. It's not really being used, because it's so overbearing and unreasonable.

MS SHIFF: I think just a subsidiary point, and it was a point made, I think, at the last hearing, is that the size of our wholesale business, and the growth of our wholesale business, is considerable. It's a big growth part of the company wholesale, and even if you could construct an argument that there is something substantively in the provisions of Part XIB that doesn't and should exist in section 46, although I dispute the substance of that argument, the reality is that when we analyse the effects of retail price behaviour we have regard to the effect on our wholesale customer base - it's as simple as that - because they are a valuable part of the business. The notion that somehow, absent those restraints, we would somehow punish those customers I think is more fed by paranoia than by facts.

PROF WOODS: Okay, XIC. At this point it's worth looking at the proposal for the revamping of declaration criteria and progressively aligning it in a more generic sense with Part IIIA. You've given strong support for greater convergence. You've identified some areas of concern that we can pursue. In terms of the drafting of the words that we've used, and particularly criteria A which is the telecommunication service of significance to the national economy. Then we've got two parts that is either in relation to services used for originating and terminating calls, and where there are substantial entry barriers to new entrants arising from either network effects or live sunk costs, or where there is a second provider opportunity.

If we look at some of the particular services, for instance the disputes that occur within the industry on the question of switching customers and protocols and procedures in relation to that, would criteria, as drafted here, be able to be captured in that process? Would local call resale be able to be brought within those words, ULL? I would be interested in your views as to whether the drafting, as put forward in our draft report, is sufficient to cover those services and facilities within the industry that are relevant to the proper functioning of telecommunications.

MS SHIFF: We have made some specific drafting comments in relation to this, which we will follow up in our further submission, and were broadly supportive of the direction in which this was headed, but were keen to not lose the precedential value of some of the words that are in Part IIIA. But I won't go into that analysis now. The problem I'm having with your question is that it's important, I think, to reflect on the fact that this provision, if it was implemented, will sit alongside a grandfathering provision. It's not like we're going to turn the clock back and rewrite

history in relation to ULL and LCR. Were we to rewrite history, then under this provision the interrelationships between LCR, ULL and whatever is coming downstream probably would have required closer analysis than occurred at the time that they were declared.

The proposal that we've put forward for grandfather provisions is simply that they pass a sort of an ongoing relevance and necessity test that the regulator bears the burden of establishing after an administratively appropriate prescribed period. So this really, I think, needs to be chucked against the wall of future services coming downstream on the supposition that Telstra's legacy network and services is going to be already substantially covered. On that basis I think that it is appropriate to ask whether, when something new comes down the pipe, there isn't something that's already regulated that's doing the job, and to draw the questioning more tightly around the essentiality of what it is proposed to declare. That is what this is, I think, aiming to do.

PROF WOODS: There's agreement that there would be grandfathering in some form of existing declarations, but it's just a useful way of testing what is here against things we know of and if this had been in place at that time would they have passed these tests.

MS SHIFF: Yes.

PROF WOODS: We're not proposing that each of them be revisited. It's purely an exploratory process to see whether the outcomes would meet - - -

MS SHIFF: I think ULL, all things being equal, would be regulated under this set of words.

PROF WOODS: If you could give some further thought to that in your further submission that would help. If you can test it against things that we don't know about, that would be even better, but we're starting to enter into the crystal ball-gazing.

MS SHIFF: Yes.

PROF WOODS: There is an argument that substantial parts of the industry are now declared anyway, so we need to look at this set of criteria in that light, but nonetheless there is some benefit in testing whether, had this occurred earlier, we would come up with the right outcomes.

MS SHIFF: Yes, I guess just going back to my earlier point: ULL would be in either through grandfathering or de novo through these provisions. It would be in, it would be regulated as I read it.

PROF WOODS: I would appreciate some exploration of that. The question also as

to non-dominant networks, whether they pass the test either in terms of significance to the national economy as one side of it, or because of the interconnectivity issue which makes them an integral component of the totality of the service.

PROF SNAPE: The tension between economists and lawyers is shown up here a little bit, I think, and a little bit more of what you're referring to is phrases that don't have legal backing, precedents, as against saying what we really want to say. We don't want to be forced into a legal precedent straitjacket just for certainty.

MS SHIFF: Yes.

PROF SNAPE: If in fact that's not saying precisely what we want to say.

MS SHIFF: Yes. No, we are giving that some more thought.

PROF WOODS: Certainly your guidance on legal precedents is relevant and useful to us, but we are not the office of parliamentary council and aren't drafting the legislation.

MS SHIFF: Sure.

PROF WOODS: We're trying to - - -

MS SHIFF: Express an intent, yes.

PROF WOODS: - - - convey a clear intent.

MR AKHURST: The instructions to parliamentary council.

PROF WOODS: Yes, well, a guidance to government. In that context you draw a distinction between economically feasible and uneconomic to duplicate. I think also that one illustrates the point of the distinction between a focus on services and a focus on facilities, and we need to keep very clear that distinction as well.

PROF SNAPE: If, in the course of that contemplation, you think of areas outside telecoms in which these criteria may not work or may be inappropriate simply because we haven't addressed - you know, there's a problem there that you can recognise from dealing with these things every day in a sense, that we may not have appreciated, then we would also be grateful for that. As you know, we've got several inquiries going on at once in the commission around us, including the IIIA. We've now also got airports, so we're having to test these in various contexts.

MS SHIFF: Yes.

PROF SNAPE: And any thoughts you've got on that, that occur to you, we would be very grateful for.

PROF WOODS: If we could ask even if they were able to be brought forward before you completed the main body of your submission, given the crucial nature.

MS SHIFF: Sure.

PROF WOODS: Not only for this inquiry but, as Prof Snape says, the interaction with a number of others would assist us.

MS SHIFF: Yes.

PROF WOODS: In terms of sunsetting of declarations, you've taken a punt at three years. The thought of every three years the local loop being subject to some process of declaration doesn't seem all that feasible. I don't know how you would cope with that.

MR AKHURST: Historically maybe.

PROF WOODS: Sorry?

MR AKHURST: Historically maybe, but we made the comments before about other technologies coming through and there may be some geographic areas where that needs consideration.

MS SHIFF: With the grandfather provisions, just an administrative reflection, is that when the transitionals were implemented in the 1997 arrangements, even the deeming statements took a period of time to just administer. So our sense is that in practical terms the sort of relevant to evoke test for the grandfather services wouldn't really cut in until - I mean, you can have a situation where, because three years has passed since the original declaration, the moment the new act commences you immediately have to go into a serious - so in practical terms it would probably be at least six years until they will have last been considered, by which time, as Bruce said, you are getting some very different technologies out there.

So in practical terms I don't think it's quite as sort of a staccato set of inquiries as you're suggesting. However, with new sort of freshly-minted declarations, it's obviously arbitrary whether you make it two, three, four, five years, but at the end of the day the history of the industry is that it doesn't want to spend three years working out the regulatory conditions of something. If you know it's only going to have a life of three years everybody has a lot more discipline and incentive to work out how to deal with it faster. So that has tended us towards a slightly shorter time frame, but others may have equally valid views on that point.

PROF WOODS: Mr Akhurst's comment about different regions may have different levels of alternate technology to the current copper local loop causes me to reinforce that the regulatory environment must capture the totality of

telecommunications competition across Australia and that when we are pursuing our final recommendations we will need to be conscious of regulations, as we are throughout the inquiry, which will continue to support the proper level of service in regions, and that may require some regulatory underpinning versus allowing the marketplace to express itself more freely in areas where there is higher demand and more competition is generated. So in giving your answers, if you could also continue to be conscious of the need to focus regulatory intent on not only those areas of the market but the geographic expression of that. That's very helpful.

MR AKHURST: Yes.

MS SHIFF: If I could just reflect a bit on regional competition, there seems to have been a spate submissions saying, "Well, if you had more access regulation there would be more competition out there," whereas we have quite a lot of access regulation and people have made choices about where they propose to compete.

If you step back from that and look at the scope for competition it strikes me that the driving imperative here is not necessarily to have lots of competitors or to have ersatz service based competition, but to have people encouraged to invest, because the problems of rural Australia associated with service quality and choice are to do with a perceived lack of investment, and hence you need a regulatory regime that is going to support the different investment models that we were talking about earlier, the potential to link hands with other local infrastructure providers or infrastructure financiers and to think about how to invest in these areas in different ways. It doesn't to my mind necessarily mean that you put in more punishing access regulation for rural Australia; it may mean the opposite, that you reflect more of those conditions into the access regulation that exists there. I guess that's our main point.

PROF WOODS: In this section on declarations you offer the view that there should be some separation of the responsibility for declaration and setting the access terms and conditions and therefore propose that the NCC would be the appropriate entity to go through the declaration process. What services does Telstra consider that the NCC may not have declared that the ACCC has seen fit to declare? Can you give me some specific examples of where you would have seen a distinction in the manner that you've drawn it in your submission.

MS SHIFF: This is very speculative, and the point that we're making here is that it doesn't strike us as kind of a good design brief to have the person who gets the resources to regulate decide the scope of their regulatory remit; that the scoping of the regulatory remit is ideally in one body and the exercise of those functions is in another, and that's the point that we're making here. I guess to speculate with the benefit of hindsight, it's very hard to see the NCC having encouraged the regulation of intercity trunk transmission and I think the NCC also just by virtue of the - and it depends a lot on what you do with the criteria associated with declaration - tend not to declare pure resale services that are not intermediate service for a participation in

downstream market. But how the NCC would exercise its functions in the future will hopefully be a function of the statutory criteria that its administering, and we're just making an observation about regulatory design in terms of separation of functions.

PROF SNAPE: I see the point there. There is, I suppose, another scenario that one could think of and it would be a situation in which the NCC in fact declared something which the ACCC may not have thought should be declared. It might be more difficult for you to think of, but conceptually it's quite possible. The ACCC then would in fact be required to be making conditions for access on something it didn't think it should have been declared for access, and so that's a practical - - -

MS SHIFF: To be a bit mischievous, my sense is that the ACCC is making conditions for access about things it thinks it shouldn't have declared in some circumstances, but it gets on with the job.

PROF SNAPE: So you wouldn't see it as a problem.

MS SHIFF: No.

MR AKHURST: Particularly if the access criteria was spelt out in a bit more detail and elaborated upon, that they could go through that job once the service had been identified.

MS SHIFF: The ACCC, a lot of their declaration suite of services were deemed - and they didn't have any individual discretion like that and they got on with it

PROF WOODS: You made reference to intercity trunk transmission as one of your examples. What, either in the regulatory environment or in market behaviour, particularly by the original builders of infrastructure, has led to what would appear to be massive overcapacity in intercity trunk transmission?

MR PATERSON: I expect it's projecting forward what demand level will be and the parties involved - - -

PROF WOODS: How far forward perhaps?

MR PATERSON: I don't know what sort of time horizon is used, but I expect parties involved would anticipate that in fact they haven't overdimensioned capacity, given the shape of the costs functions they face in putting in capacity and the very low incremental cost of putting in additional capacity once you've allowed a cable or opened up a trench and know the enormous growth in traffic volumes on those links in recent years. I think those things taken into account, it seems to me those parties wouldn't think they had overdimensioned.

PROF WOODS: So you think that the current behaviour is purely a commercial judgment on the part of new investors as to whether it is better to access on

reasonable terms the facilities of existing providers versus the business case of building new facilities themselves.

MR PATERSON: I would expect so, yes. I expect they'd taken those hard commercial decisions.

MR AKHURST: The unit price has fallen quite dramatically too, as I understand it.

PROF WOODS: Nowadays.

MR AKHURST: The unit prices has fallen quite dramatically, which means they can enter the market.

PROF WOODS: You offer a number of comments on the proposed pricing principles, and we thank you for those. You offer five more with a suggestion that you might even add more to it. I'd prefer to keep them clear but also a little succinct; I think too many and we'll lose the plot. So when you do put in your final submission, if you could give consideration to that trade-off between overt complexity and thoroughness versus some form of simplicity and guidance.

In your list of additional possible principles you raise one: the regulator should be required to fully reflect service obligations and community expectations about service levels in regulated access prices. Service obligations, if we can look at that as a start: would your preferred position be that wherever there is some form of community service obligation that that is funded externally to the organisation rather than built into the pricing as such?

MS SHIFF: This is not reflecting the USO issues at all. It's reflecting that one of the points at issue over the past few years between us and the ACCC has been that when they optimise their network models they don't design for the network typography that's required and the level of redundancy that's required to meet customer service guarantees for example, where you have to have spare line available within a certain time frame and you have to deal with volts within a certain time frame, and those time frames have been made stricter and stricter, and there's every expectation that that sort of tendency will increase, and that then has reverse implications for your investment profile, and yet there's a disconnect between those forward-looking investment decisions to deal with those service standard issues and how the ACCC views the necessity of that investment and whether it gets reflected into the regulated asset base. So this is really just a plea to bring those two issues together in the analysis. Did you want to add anything more?

MR PATERSON: That covers it.

PROF SNAPE: Perhaps I could pick up the principle of financial capital maintenance in your pricing policies, and I take the point about asymmetric risk that

you make there. You've got a sentence here. It is:

> Owners of regulated assets should be allowed to recoup the capital invested in such assets over the lifetime of the investment where such investments are considered prudent at the time they were made.

Now, considered prudent by whom?

MR PATERSON: In fact, in this context it would need to be an ex post consideration. It would be considered by the ACCC in this case that the regulatory body considers it prudent in that regard. Of course not all prudent investments actually turn out to be financially remunerative investments in that market conditions don't always play out as one anticipates, and that would need to be taken into consideration.

PROF SNAPE: Yes, but I think you get the problem, that you're having to sometime down the track say, "Well, you know, was that a reasonable investment in the time?" or should they have anticipated that such-and-such was going to occur, or that the Australian population was going to decline, or that there was going to be a shift of population from part of the country to another? I mean, you can just off the top of your head like that think of all sorts of things in which the regulator would be in an impossible situation. Even if you can get over that little hump, you're then stuck with the fact that you are going to guarantee a return on something which you subsequently judged to have been prudent, which means that you're taking a good bit of the risk out of it, and you would then say, "Well, perhaps we should no longer have any risk rating on the capital."

MR PATERSON: Of course that would need to be taken into account - the way risk is treated in that regard - if it was to proceed along those lines in establishing what is the appropriate WAC in that regard and what risk is covered off by that particular element.

PROF SNAPE: I think there are a great many dragons around this one and I think it needs a great deal more consideration than you have given here, for some of the reasons I have just been indicating.

MR PATERSON: Yes.

PROF SNAPE: It could in fact become to a socialisation of the investment very rapidly, in which case you would have to ask yourself if you would be satisfied with a long-term bond rate and, if so, why have it in the private sector.

PROF WOODS: It seems to be a theme running through all of your additional contributions there, that although your general proposition to the commission has been that the marketplace is now sufficiently robust to be able to deal with a number of issues there seems to be a strong counterbias here that the regulator should be

protecting the investor in quite a number of ways from the vagaries of the marketplace and perhaps when you're putting your final submission if you could look carefully at how that is constructed.

MS SHIFF: It certainly wasn't our intention to reflect that and I think this particular issue is of course not at all peculiar to telecommunications. It is very, very relevant to - - -

MR PATERSON: Electricity transmission or gas pipelines.

MS SHIFF: And airports and gas pipelines and rail and all the guys who are going to bob up during the Part IIIA hearings, but I think what we share as infrastructure investors is a desire to sort of know when we're putting in a new investment how it is going to be treated over time and to avoid to the extent possible ex post facto kind of analysis of whether it was prudent. It's particularly difficult in telecoms because what seemed prudent at the time is invariably judged not prudent because of new technologies that subsequently emerge, so those were the kinds of issues we were trying to come to grips with in this discussion, but we will certainly give it some more thought.

PROF WOODS: In the suite of our draft reports and position papers we do draw that distinction in telecoms as the change of technology to say railways or gas pipelines or electricity transmission, so we understand the point. It is how it gets expressed and - - -

MS SHIFF: Gets expressed, yes.

PROF SNAPE: Not to mention the solution.

PROF WOODS: In terms of the solution, I was struggling with how you would give actual expression to providing strong incentives for producers to achieve productivity improvements. I mean, that is a key theme of our commission and it occupies a lot of our thinking and therefore your comments strike a chord with us, but the actual implementation of it is - - -

MR AKHURST: I don't think we are seeking to ask for a guaranteed return or not to face risk. On the other hand we don't want the initial costs to be ignored down the track. How you actually express that and get the right balance is the challenge.

PROF WOODS: You would just like as little risk as you can get away with.

MR AKHURST: Maximum return for that risk - no - no, it is a balance.

MS SHIFF: I mean, there are certain types of investment where you may from a social policy point of view decide you want it to be more insulated than others, you know, and it just strikes me, just going back to our discussion on submarginal

investment in regional Australia, that where there are marginal investment decisions to be made maybe there is a social policy reason that creates a more forgiving environment than a very fast train or something else between capital cities or whatever. There are some public policy issues that do interleave this discussion.

PROF WOODS: As you're aware, we have additional terms of reference where we're required to have regard to the differing levels of competition across Australia and consider whether greater recognition of those differing circumstances should be incorporated into competition regulation - and we have raised that issue earlier - and then also to look at the implications of current pay TV programming arrangements for the development of telecommunications competition.

In the early part of your submission to us you express views that talk about incentives for facilities-based local loop competition - you talk about encouraging efficient investment in alternative delivery platforms - so there is a theme that you build in in the early part about having greater competition, and it is in regional Australia where that competition is not yet as fully developed as in the CBDs and, to some extent, other business centres in Australia, and yet when we get to behaviour in relation to pay television we have been asked to look at whether current programming arrangements inhibit the development of telecommunications.

You make several responses about exclusivity and you talk about "in markets dependent on content it's uncontroversial that there be an approach to attract and retain subscribers". You claim it's similarly uncontroversial that in normal commercial practice in such markets you seek to secure content through exclusivity arrangements. I can understand that perspective for a company involved in delivering content but I don't understand its behaviour necessarily in a company involved in providing the basic facilities through which that content is delivered and, in your own admission, you're looking for greater facilities-based competition.

To draw on perhaps a local anecdote, but given that Telstra is a 50 per cent owner of Foxtel, Foxtel is currently advising Canberra consumers that its product will not be available on Transact's open access cable, but instead uses the more costly, I would have thought, delivery vehicle of household satellite dishes and set-top boxes. I look to an explanation of Foxtel's behaviour in that respect and look to any implications that may have for the viability of Transact who, in accordance with the themes you express early in your submission, is doing exactly what you're wanting, having more facilities, competition, at the local level. How do you, in Telstra's mind, as a large owner of Foxtel, reconcile that issue?

MR AKHURST: I think how Foxtel delivers its pay TV services is really a matter for Foxtel rather than Telstra, and I am not sure if Foxtel are coming to talk to you - - -

PROF WOODS: They might.

MR AKHURST: They may be better in talking about what is happening in Canberra than we are. I am not familiar with it, myself.

MS SHIFF: Notionally - and this is not speaking on behalf of Foxtel - you would want to put your product on - it's the same principle that applies to using the CAN or using something sort of cheaper or more appropriate but, to be absolutely honest, we are struggling a bit to understand what the issue is here and we don't have hard and set views on it. We are just struggling to come to grips with it because in the case of Neighbourhood Cable which, I think, has precipitated the ACCC's concern, it seems to be driven by problems in accessing Hollywood movie studio content and clearly there are issues around who gets it and at what price that then flows through to Australian consumers. I mean, there is an issue there. Whether this is the way to deal with it I'm not sure, as a content issue.

As far as sports are concerned it just seems to us that - and there are others, I think, who will probably want to comment on this, as well - that the anti-siphoning rules have created a very unusual market for pay TV operators where there is less to buy and the price goes up accordingly and I don't think much can be done about that without dealing with that underlying distortion.

As far as the ability to source content on to Web TV or video cell or ITV or whatever else comes along, our sense is that, well, okay, Neighbourhood Cable isn't a production company but, if it had a relationship with a production company or a local TV house and it wanted to generate local content and, arguably, local content will drive those services, not marquee content - like the local restaurant guide - and some educational stuff and stuff that people in the local community find gripping, and that is valuable content, then if you enter into an arrangement to develop that product you want to have the exclusive distribution on it. Otherwise you develop the product, like say XYX, the local Australian content channel that's jointly owned between Foxtel and Austar - you would develop all this local content - arguably, a lot of it other people could have developed, but they took the risk on certain categories of entertainment and certain performers, and once they get an audience then they're required to distribute it more widely.

That to me would strike at the heart of local content production, so I guess we're just trying to come to grips with what is really going on here in terms of what needs regulating from a content point of view and just express some concerns about not taking this too wide, relative to the problem in hand. As far as translating it across into the competitive arena we feel quite strongly - and we have more I guess direct experience of this - that this is not driving competition in regional Australia; that Austar could very well argue that absent the exclusive content they wouldn't have had such an effective entry strategy for Internet and sort of new forms of telephony and, from the Australian regional consumers' point of view, they're getting the content the city folk are getting, and that kind of tends to be what they worry about.

Just for argument's sake Neighbourhood Cable had all of the Hollywood studios you know at a reasonable rate does that mean they would compete more effectively on telephony? I don't think so, because they've still got issues that need to be grappled with in mainstream telecommunications regulation, which is the price caps and the distortions around what you have to - where you have to price in a market that has been essentially distorted by historic price regulation and the fact that you're dealing with people who have got non-cost reflective regulatory source products like local core resell. I mean, that is what is killing people who are trying to put in facilities based loops in regional Australia. So we see this as this a very low order issue relative to those issues and are still trying to understand what the content issues are really about, I must say.

PROF WOODS: That takes you in a different direction to some extent than what you've put in here and I'd appreciate an elaboration of that in your subsequent submission. But the points of view that have been put to us in response to the extension of our terms of reference are very clearly that to have a viable business model for facilities, particularly local loop competition, in regional Australia, you need content in terms of sport, in terms of general entertainment and perhaps Internet, and that telephony in itself is not a viable business model, so you need other revenue streams to which you can then also add telephony as a part of a package, but the facilities won't stand on telephony alone. So that's the issue, and I appreciate you probably understand that. It's just how it gets expressed.

MS SHIFF: Look, put that way we can certainly give greater thought to the business case in the overall economics of regional entry with and without pay TV, because a lot of this debate is solely associated with the content that's related to pay TV and not necessarily other content based broadband services.

PROF WOODS: No, the focus is on if somebody has a large component of potential pay TV content and that is being denied those who are trying to build business cases for alternate local loop facilities in regional Australia - then that is inhibiting the development of additional facilities which in themselves won't be a sustainable business case primarily in telephony and telecommunications.

MR AKHURST: But would you have a viable pay TV business to start off with if you can't have some degree of exclusivity in content?

PROF WOODS: No, the question is not whether you have exclusivity of content for the providers of the content service, it's whether they then tie themselves to those who provide the delivery facilities, and that's where the focus of our inquiry is. A company that has a range of content exclusively could still choose to deliver it through a number of open access channels which assist in the viability of those channels, and arguably in some cases it may even be cheaper to deliver it down through a cable channel that's already connected to households than to go through the process of putting up individual satellite dishes and exclusive set-top boxes and all the rest of it. So that's the issue. It's not questioning whether a pay TV content

company has a right to exclusive ownership of content. That has a business case all of its own and I don't think there's any significant debate.

PROF SNAPE: In that there's always the question of what sort of contract the owner of the content will - the contract that they will require of course - - -

MR AKHURST: Absolutely.

MS SHIFF: Yes.

PROF SNAPE: - - - and how they're going to be getting maximum benefit for themselves.

PROF WOODS: To some extent we have an interesting parallel, that the industry has moved to having providers of microwave towers as independent facility owners and operators, and then different telephony and other companies hire space on those towers. Now, that seems an open access model that could then move to other facilities within this industry generally. I mean, the tower operator doesn't care what the content is that's going through the dishes just as long as it gets the rent from those who have got their dishes on the tower. One could argue that really the move to open access cable is not that much further along the evolutionary line.

MR AKHURST: But the pay TV operator would still retain direct contact with the end customer.

PROF WOODS: Yes, that's right, and just use the facility as the conduit.

MR AKHURST: Yes, okay.

PROF WOODS: And you could use numerous facilities, including ones that might compete with Telstra's wholesale perhaps. You haven't provided comment on questions of industry development plans or our proposals regarding non-binding indicative time limits and the like to any degree, but perhaps in your further submission, if you could address those points for us to clarify your views, that would be helpful.

PROF SNAPE: I'd like to go back to facilities based competition. Outside central business districts and other perhaps densely populated areas, very densely populated, do you really expect facilities based competition for local loop? In Telstra, in thinking ahead, in thinking of where it's going, would you really expect significant local loop competition outside the central business district or similar areas?

MS SHIFF: Look, it's a very perplexing question because the economics are everything that you say that they are in your draft report in terms of the lack of density and the increasing costs. But having said that, one is frequently confounded, when you think you know the answers to things in this industry, by the next

technology that comes along, and it is notable - and we should do you a note on this relative to the survey that you've done - that there's a huge amount of spectrum out there. For example, there's a lot of 3.4 gigahertz spectrum that Steve Casser brought up last year that is ideally suited for wireless local loop applications and has a very large footprint across Australia. There are also satellite applications that are coming downstream that can do two-way broadband and voice, and there are competing satellite consortia that are still in the pipeline.

So the potential is there to have competing technologies in rural Australia. The question is, is anybody going to invest, and maybe it requires different ways of investing to support those propositions rather than to - which I think would be really unfortunate - make a public policy on the basis that nobody is ever going to invest there so we should just close that door to the potential.

MR AKHURST: The other aspect comes back to a slightly different thing. There may be different technologies - whether there are different competing technologies and competing operators - but also that it won't necessarily be Telstra, even if there is only one operator, that will be there. Now, going back to your initial point about our organisational arrangements, yes, our customer base units could be looking at other operators to provide the service and it might mean that our service is sold or becomes redundant, to use that word again, and someone else comes in.

PROF SNAPE: So they would be fairly free to do so.

MR AKHURST: Yes, we don't have a rule that they can't do that. Historically there hasn't been our way of operating, but this is part of this transition we're making, that that is part of the thinking definitely.

PROF SNAPE: Maybe we'll come back to that in just a moment.

PROF SNAPE: Can I just pick up one specific thing - retail price controls. You've dealt with it to some extent in your report. Have you got any views on the way in which we dealt with the issue, where we supported the ACCC's recommendation - 10.2, as I recall:

> The commissioner recommends that retail price controls that lead to the access deficit be removed.

Do you have a view on that?

MR PATERSON: Yes, I think on that point it's a not unsurprising recommendation. Many of us in the industry have realised that many of the pricing issues and pricing distortions that we face stem back to the retail price regulations. We also realise that there is a certain political imperative around some of those regulations and their removal. What wouldn't make sense is to have those arrangements withdrawn but Telstra find itself in a position where, for political

reasons, it was impossible to rebalance at the rate that would be allowed under a straight withdrawal. Hence, in our submissions on the price control arrangements we've proposed a time path for rebalancing which would need to accord with political imperatives but be obviously moving in that direction of eliminating the access deficit.

PROF WOODS: So there is nothing in our report that caused you any surprise and - - -

MR AKHURST: Well, no surprise but I think if I recall correctly what your recommendations are, our view is somewhat different, that what we need is a time path or a glidepath on elimination of the access deficit.

PROF WOODS: No, I can understand your transitional issues that are peculiar - well, not totally peculiar to Telstra but particularly high in your mind.

MS SHIFF: I think the end point we all agree on; it's how to get there. We also see it as quite vital in terms of the long-term viability of infrastructure competition that these settings are redone, but it's how you get there.

PROF SNAPE: I wonder then if we could come back to the big picture and ask if you could reflect and give us a big picture of the future, a vision of the future in this convergent world of various technologies, much of which of course is uncertain for the future, but nevertheless we can see this convergence of broadcasting, Internet, telecommunications, the importance of broadband of one form or another, the importance of two-way paths in broadband and not just a one-way path in broadband, that whole sort of scenario, that whole big picture that's here. We really haven't got this from Telstra, if I my say. We haven't done it in our draft report, but I think it's fair to say that no participant has in fact given us a sort of big picture of the future, and Telstra, as the biggest player - I don't use the word "dominance", you'll notice - in this is perhaps best placed to be having that sort of big picture.

We haven't got it, and I wonder if you could, but also what you see as key regulatory barriers, if there regulatory barriers or behavioural barriers, not just strictly in telecoms - and of course I'm now thinking across into broadcasting, the whole spectrum - well, that is the word, isn't it - - -

MR AKHURST: It is.

PROF SNAPE: - - - in this area of where should we be going; what should we be getting excited about; where should we be going in this and what's holding us back.

MS SHIFF: Yes.

PROF SNAPE: I mean, so much of it has been on nuts and bolts and, as I said at the beginning, very defensive at times of, you know, "Okay, we can't go out there

because of this" or "because of that. We'll only give the information that we're required to give," instead of getting on the front foot and going out there and saying, "This is where we want to go. This is where Australia should be going. Now, let's get there," and something you can get excited about instead of defensive and having the lawyers out. This industry is so besotted with lawyers and, you know, can we get going and not be held back by this defensive, litigious view of, "If we do that, that's a precedent for this and that and the other thing and we're going to be taken to the cleaners"? In other words, can you get a bit of excitement into your presentation? Can you find, "This is where Australia should be going. Let's try to get there"?

PROF WOODS: Let's listen to Telstra's answer.

MS SHIFF: You've given us a draft report that has very, very detailed recommendations which we've tried to do some credit to by giving you very detailed answers to those very detailed questions.

PROF SNAPE: And we're grateful.

MS SHIFF: But I 101 per cent agree with you that it's not about rewriting history and looking backwards; it's about looking forwards. We believe, even though some of us are lawyers, that there is too much legal overlay and not enough time spent in innovating and creating and getting the services out there, and we also believe that the industry in Australia has a fantastic future and that the broadband services are not going to just be dependent upon pay TV for compelling content applications - that is almost sort of passe. It's a journey on the way to new point-to-point very interactive and sort of niche services and that would fold in really well with the opportunities that exist in regional Australia.

We haven't written off investment in regional Australia. We think there are heaps of opportunities there and we think there's heaps of technology in the pipeline, so if we haven't focused on that we apologise. It's partly to shift the blame because we are trying to get our heads around the very, very detailed sort of suggestions and recommendations but we would be more than happy to go there.

PROF SNAPE: Thank you very much. I mean, if there is blame it is with us, as well. We are trying to get our heads around extremely difficult concepts, as well, and of course one gets drawn into the minutiae very, very quickly, but I think it is time to say, "Okay, now let's open our minds."

MS SHIFF: Yes.

MR AKHURST: I mean, there's big time, long-term bets that are being made on technologies, and you really want to encourage people to do that rather than, as you say, have the legal and regulatory departments of companies running the industry, and that is what we would like to see. We don't think it can happen unless there's a less intrusive, more supportive-type regime here. That's why we keep going on

about this "infant industry concept". We really do think it's time.

PROF SNAPE: But we also do need a competitive industry to be giving that sort of benefit and so that's the thing.

MR AKHURST: Absolutely, yes.

PROF SNAPE: We don't want a picture of, "Okay, so long as Telstra is allowed to do what it likes Telstra will be the industry." No, because we all know what that could lead to.

MR AKHURST: That's not our objective either. We firmly believe that competition has been a terrific thing for Telstra itself.

PROF WOODS: All right. Are there any other final matters that you wish to put before the commission in this hearing?

MS SHIFF: There's a lot of detail - a lot of detail - in the draft report and we have tried to pick out what we think are the critical design elements, but we'll go back to the detail in our subsequent submission and take it piece by piece and we'll be on the phone to Hugh Bradlow the moment we leave - from Telecom Research Labs - to figure out what everything is going to look like in four years' time. He will give me about 10 scenarios, I am confident.

PROF WOODS: All right.

MS SHIFF: Thanks for the opportunity to comment.

PROF WOODS: Thank you very much. That will conclude our morning session. We will resume at 2 o'clock.

(Luncheon adjournment)

PROF WOODS: Good afternoon, ladies and gentlemen. We will recommence our hearings into the draft report of the Productivity Commission into telecommunications specific competition regulation. We have before us representatives from Cable and Wireless Optus. Would you please indicate names and positions within your organisation?

MR FLETCHER: Paul Fletcher, director, regulatory affairs and interconnect.

MR SUCKLING: Adam Suckling, group manager, regulatory.

MR FRANCIS: Derek Francis, manager, regulatory economics.

PROF WOODS: Do you have an opening comment you wish to make?

MR FLETCHER: Yes, we do. In fact we've got some comments spread across the three of us, so if you are happy I will launch into that. Let me start by saying first of all, thank you for the opportunity to once again appear before you and make some comments about the commission's draft report. We should say at the outset that we feel the commission has done an impressive and comprehensive job in its analysis of the telecoms industry and that the commission has made a number of very sound recommendations; in particular we agree with the recommendation that the test for declarations should be narrowed to more clearly catch bottlenecks.

We agree with the commission's recommendation that the retail price controls on Telstra should be reformed. However we don't, unsurprisingly, believe that the commission has got everything right. I guess, in this mortal world there are few who can achieve that. Nevertheless, much of what the commission has done we do agree with but there are some areas of disagreement, so what I want to do is quickly give you an overview of our response before asking Adam Suckling to touch on our views in relation to Part XIB, and Derek Francis to cover Part XIC.

Let me turn to talk about what we see as some issues in overview, where we have come concerns with what the commission has recommended. We do believe there are some problems in the commission's approach which undermine its analysis and call into question some of the recommendations, and I think we see perhaps four broad problems. Firstly, we think there is something of a disconnect between the commission's analysis and the first part of its report and its recommendations, so in the first part of the report the commission identifies unique characteristics about telecommunications, such as high sunk costs, network effects and high switching costs, which presumably would tend to support a telco-specific approach to regulation.

However, in the latter part of the report the commission recommends moving towards general competition law, such as, for example, its recommendation to scrap Part XIB, which appears to assume away the unique characteristics which were

identified earlier and we don't feel the report adequately demonstrates how the general competition law regime would deal with the unique features identified earlier in the report. That is what we see as the first broad problem.

The second broad problem, we feel, comes in the commission's approach to access pricing. We think the report focuses too much on Telstra's incentives to invest, when much of the data conclusively demonstrates that Telstra's incentives to invest are intact. Derek Francis is going to, in real time, provide some new data on that point today to illustrate that point. We feel the report almost exclusively focuses on Telstra's incentives to invest and doesn't look at the incentives to invest of new players, including of course struggling small players like ourselves. New players' incentives to invest can be fundamentally impacted by the price of access to the incumbent's network.

Thirdly, we don't feel the commission spends enough time in the report exploring the deleterious effects that the retail price controls on Telstra have on access pricing, incentives to invest and consumer welfare. That is, as I say, the second of the four problems that we believe the exist. The third of the four issues that we see with the report is that we don't think it adequately focuses on the inter-dependencies between different parts of the regulatory regime; for example, we don't feel that it adequately acknowledges the inter-dependency between behavioural safeguards and access regulation and we feel that it does not sufficiently draw out the inter-dependency between retail price controls and access pricing.

Then a fourth issue is we feel the commission does not pay sufficient attention to some significant issues which are having an impact on competition, such as retail price controls, barriers to entry erected by inefficient processes; for example, the highly inefficient number portability processes, the lack of non-discriminatory access to key pay TV programming, and then government-erected barriers to competition, such as the requirement for all new carriers to provide the customer service guarantee.

Based upon those four problems we believe there are some conclusions and recommendations that the commission has reached which we would not support. The recommendation that Part XIB be repealed, in our view is not appropriate and we don't think it's clear from the report how the alternative remedies that the commission is pointing to - namely, section 46 and Part XIC could effectively deal with some of the unique characteristic of the telecoms industry, which the commission has highlighted. Adam Suckling will touch on this in more detail.

Secondly, the commission recommends a streamlining and tightening of the approach to declaration. In principle we agree with that. However we do feel that the enthusiasm for recommending a one-size-fits-all approach means that there will be recommendations on access which are overly complex. The approach will tend to be too slow-moving and it will not capture all local loop services which bestow significant market power on the incumbent.

Again at a high level, what do we believe the commission should do if it were minded to agree with the propositions we're putting to you? We think there are a couple of changes - or in fact several changes we'd like to see in the commission's final report. We think the commission should recommend the retention of Part XIB. We do agree with the recommended tightening of the declaration criteria and we agree that the current declaration process has thrown the net too wide. We do feel though that the proposed criteria suggested by the commission are too complex and onerous and we would recommend instead the use of a significant market-power test, as has been used in other jurisdictions, including for example the European Union.

We feel, thirdly, that the commission should focus more attention on retail price controls and give more attention to that and less attention to the very drawn-out analysis on Telstra's incentives to invest. We regard retail price control as a major inhibitor to investment and to enhance consumer welfare, and we think it is critical that the commission should take into account the impact of access pricing by the incumbent on incentives of new entrants to invest in infrastructure.

Fourthly, we think the commission should give more analysis in some other areas; for example, the application of a CSG - the customer service guarantee - to new entrants, and the lack of non-discriminatory access to key pay TV content. After my colleagues have spoken we would be happy to take questions. We have provided you with a draft of our submission. Chapter 5 on the USO we're still working through, so we would prefer not to address that, but the rest of it we're happy to engage in. I am happy to turn over to Adam Suckling.

PROF WOODS: Mr Suckling?

MR SUCKLING: Thank you, Paul, and thank you, commissioners. I am just going to take 10 minutes to go through the broad issues with the recommendations on Part XIB. As Paul has said, we live in a mortal world, so some of this will focus on issues and problems we perceive with the recommendations. There are three parts to my presentation and we will firstly look at problems with the commission's analysis; secondly, outline what we think the commission should do in its next report - areas it should focus on - and, thirdly, I'll talk about the recommendation we think the commission should make.

Turning to my first point, which are the problems we think are in some of the commission's analysis, and I guess we would identify six areas where we would argue things could be fleshed out or changed. I will go through each of those areas in turn. The first one is the disconnect point that Paul made. We think that the commission identified a set of unique features at the beginning of the report, such as sunk costs, network effects and high switching costs, which would lead one to presume that you would favour some form of sector-specific regulation, but then when it comes to Part XIB the preference appears to be to sweep away - at least the first option is to sweep away - Part XIB.

We disagree with that. We think that the unique costs that the commission identifies in the first part of the report are things that would support the keeping of Part XIB and we think that the case of local call resale illustrates that very, very well. As the commission is aware, the ACCC handed down a number of competition notices in relation to Telstra's local call resell churn process. The importance of that churn process was it was a process that sat on top of Telstra's bottleneck control of the local loop. It was a process that Telstra controlled and it was through which Telstra sought to increase switching costs to a level which meant that people couldn't switch customers.

So the sorts of things that Telstra did was, they had a $30 switching fee if you agreed to incur all debts of that customer once they had moved over; a $15 switching fee if you agreed to incur some debts. You had to agree to take on an uncapped liability. You had to agree to a $7 rejection fee and you had to agree to the requirement to provide the Telstra account number which most customers didn't have. We think that that example is a good example of where unique features of telecommunications can be used to undermine competition and we'll provide you with more detail on that.

The second area we would comment on is that we think that the commission's own paradigm that it sets out in its chapter on Part XIB would lead it to support, rather than reject, the notion that you should use Part XIB. The commission sets up a paradigm in which it identifies type 1 and type 2 errors. It says that type 1 errors it identifies as an overuse of competition notices, which would be deleterious to investment and so on, and type 2 errors where there is a non-use of a competition notice when there should have been a use of a competition notice. The commission's draft report says that they believe that there was a risk that there would be too many type 1 errors, and therefore that adds some credence to the argument that Part XIB should be removed.

We would say in response to that, that you can't sort of have it both ways. You can't, on the one hand, say Part XIB hasn't been used enough and therefore there's an argument to say it should be removed, and then at the same time say that there is this big, big risk of type 1 errors and therefore there's an argument in favour of getting rid of it. We in fact would say that the risk has been more on the other side and that there have been type 2 errors rather than type 1 errors and the notice has not been used enough.

The third point we would make is that we don't think, in the commission's report, that they have properly compared the alternative remedies to Part XIB. So the commission says in its report that section 46 is a possible avenue you could use. The commission, absolutely rightly enough, criticises Part XIB for being too slow, and points out that one of the competition notices took 11 months to hand down. There are some quite good - looking at section 46 - but in our view the commission doesn't go far enough in seeing how that would practically work. Our experience in

a section 46 case is that we are three and a half years into one, and we've discovered more than 25,000 documents and still aren't that close to a resolution. I guess we would argue that, in relation to comparing the alternatives, Part XIC would not have dealt with some of the problems that Part XIB has addressed, and we will provide more details on that.

Finally, in relation to this question of whether the alternatives have been compared, we wouldn't support the argument that an effects based test is very similar to a purpose based test, which I think is one of the implications in the commission's reasoning, because you could engage in behaviour which undermines the competition quite substantially, but if you can't prove purpose under 46 it would go ahead. The final point I'll make on the comparisons that are made is the question of the onus of proof. The commission says that the onus of proof is reversed in this instance.

I think having tried to get two competition notices up against Telstra, it really is a little bit like climbing Mount Everest. You struggle all the way up and when you finally get to raise the flag on the top of the mount that is when a competition notice is handed down. The commission is very risk-averse to handing down competition notices. You have to go through a lot of processes to prove that there has been a substantial lessening of competition and it's only after very lengthy processes that they are prepared to move on it.

I'll move on quite quickly on the final two points. The commission says in its paper that competition notices have in general only had distribution effects, rather than efficiency effects. We will provide evidence to the commission to suggest that the use of the competition notice and the instance of Internet interconnection has led to very, very real declines in prices for a product that is quite elastic and that there has been a consumer gain. We didn't provide that evidence to the commission the last time. That was our fault and we will seek to provide that to you to convince you that we're right on that point.

The final point is the question of incentives to invest. As Paul Fletcher said, one of our issues is that we think that there has been a little bit too much focus on Telstra's incentives to invest, and certainly in the case of the Internet interconnect case, we couldn't have continued to invest in a very, very expensive ATM backbone network if we hadn't been able to get rid of the anticompetitive peering arrangements or Internet interconnect exchange arrangements that we have with Telstra.

Turning very quickly - I'm now running out of time - to what we think the commission should do. It will come as no surprise to you that it's the sort of converse of what I've just outlined. We believe that there should be a better integration of chapter 2 with other parts and conclusions of the report. Secondly, we believe that a little bit more work should be done on comparing the alternatives to Part XIB. Thirdly, we think that the evidence from local call resale, Internet interconnect and any other competition notices, should be put against the commission's type 1 and type 2 schema, and we think it would lead to slightly

different conclusions to the ones that you currently have.

Fourthly, we think that Part XIB has led to increases in efficiency and consumer gains. We will provide those to you, so we think there should be a focus on that. Fifthly, we think the commission should take into account incentives to invest by non-Telstra players. So it would come as no surprise that our final conclusion, the third part of this presentation I said I would cover, which is what should the commission recommend, we would advocate, as Paul said, that the commission should stick with its option 2 and recommend retaining Part XIB, but we would have some comments on the modifications that the commission recommends to that part. Thank you.

PROF WOODS: Thank you, very much. Mr Francis.

MR FRANCIS: Thanks very much. What I'll be addressing in our submission are chapters 2, 3 and a little bit of 4 essentially, which discusses the commission's recommendations on the access regime. Essentially most of our thesis, in terms of attempting to establish a vision going forward, is to only apply pro-competitive regulation where there is market failure. The only area of significant market failure at the moment is Telstra's fixed local loop. We've seen a fairly interesting and expansive investment program in other areas. It doesn't necessarily matter how you structure your competition regulations, so long as you get to the end game of promoting investment, competition and society's welfare, and so long as you sweep away a lot of the government-instituted barriers to entry, then this report will be judged well and will gain the support of carriers and industry more generally.

So in this respect I think our core recommendations - and I'll be going through some of the data on this - are that the discussion on the access regime is all quite interesting, but at the end of the day that's not the crucial inhibitor of investment in core infrastructure and bottleneck services. It's retail price controls that do the major deleterious impact and I'll be going through some of the data on that. The commission has spent an awful lot of time in its discussion, three chapters, on access regimes, and perhaps a few paragraphs on retail price controls.

I think you could probably do a fairly simple economic demonstration to show the actual welfare effects of retail price controls, and probably about 100 times worse in terms of the effect on welfare than the access regime. So in terms of a principal focus of getting competition, fully-fledged facilities-based competition, into the industry what our essential thesis is, is that you need to focus on removing those government-erected barriers to entry, and we don't think the access regime, as it has practically been implemented, has been a barrier to entry in terms of the empirical data and we think that there are other issues that are more important in terms of those barriers to entry and barriers to investment and competition.

In terms of what we recommend for the commission, it's partly tied up to that essential thesis. If the only area of significant market failure is the fixed local loop,

then essentially you target your regulations to deal with that. You make sure that in prospective new economy markets is just unbundled local loop services; that Telstra can't cross leverage market power to establish a downstream monopoly there in new economy services. You promote facilities based competition, so you promote essentially cost based interconnection for facilities based competitors to Telstra's fixed network and you also promote resale competition as a stepping stone to fully-fledged facilities based competition.

What we essentially recommend is a test for fixed local loop services, which is a substantial market power test which is essentially very similar to that undertaken by the European Commission, and our proposed regulatory design is also very similar to the current regulation currently undertaken in the US. Essentially what we think is that there is a critical shortage of investment and competition in fixed local loop services, and Australia is falling behind. It is not because of the current practical implementation of the access regime, but it is because of insufficient targeting of Telstra's local loop fixed market power and retail price controls that are causing the problems.

So it doesn't necessarily matter how you get there. The principle of sort of generic competition law is a fine, theoretic principle but if, at the end of the day, you throw out the baby with the bath water and you don't actually proactively promote competition and investment in the area of market failure and you have this generic regime that actually targets new entrants and raises barrier to entry, then essentially you might be actually getting worse outcomes than better outcomes.

In terms of going through some of our positions, we agree with a lot of what the commission has recommended. We agree with the replacement of an LTIE test with an economic efficiency test focused on the aggregate of consumer and producer surplus. We would make special reference there to the role of competition. What we observe in other countries that are doing better than Australia is fully-fledged facilities based competition, and that leads to a competitive dynamic where everyone is investing and innovating, et cetera. Here we've got a bit of a backward, competitive dynamic in some respects, and that's probably because of a little bit of a lack of facilities based competition.

We support that the declaration test should be tightened, but as I've said we support a substantial market-power test for the fixed local loop services. We think declaration has been extended too far without economic reason. Some examples of that are inter-capital city transition, mobile networks and cable delivery of analog subscription TV services. I could talk all day about these three and why they should never have been regulated, but I'll skip that one. Access holidays for prospective marginal investments: again, we support that. I mean, at the end of the day, if they're contestable and marginal investments the best regulator of them is market processes and that regulates the prospective returns.

Our experience has been that you take a risk and you get into an investment,

then if it turns out to be a loser you're left carrying the loser and if it does turn out to be successful then there might be a regulator out there that sort of - X comes in and observes monopoly profits and thinks they want to get in there and regulate, and that just distorts the incentives - - -

PROF WOODS: I would like to explore a bit of that asymmetry of regulatory behaviour.

MR FRANCIS: Yes, we can explore that throughout. So what we say is that fixed local loop is the only area of significant area of market failure. Telstra essentially still maintains 95 per cent of fixed local loop connections. It is only going down fairly slowly. The reason for that is largely fixed to the costs associated with doing it and also government-erected barriers to entry such as the application of a tighter set of environmental planning laws to entry networks than when Telstra rolled out its network. We have got local councils now that are potentially attempting to try a discriminatory levy, discriminatory charges on us for rolling out our networks. The big one which we can spend all day on is retail price controls. Network affects the natural monopoly characteristics.

So what we say is that the access regime needs to focus on this and the current commission declaration test - we're not sure how it would apply, but if it potentially sets the bar too high for all of these services then you're not essentially tackling your area of market failure, and so we say that that could pose problems. I think we give examples in our paper, that I won't go through, of why we think it might not necessarily apply to such things as local core, commercial churn services, number portability, even unbundled local loop services, because they're data services and not fixed services.

PROF WOODS: We might explore a little bit of that.

MR FRANCIS: Yes, depending on the time. Richard has asked for a vision so I propose to use the slide projector to generate a little bit of - this is attempting just to show areas of market failure. I'll go through some of these slides. The first one is unbundled local loop services. We've put these in our submission, so you know I've given Ralph the hard copies of all this benchmarking data, but essentially what this is is the price of bringing Telstra's unbundled local loop relative to international comparisons. What we find is Telstra's proposed charges are three times world's best practice.

What we're talking about here is, we're talking about the prices in the CBD of Sydney and Melbourne, and metropolitan Sydney and Melbourne, so I can't see why those particular prices will vary from CBDs in other countries around Europe and the US, because essentially we've got exactly the same network topography. In terms of the actual ACCC's implementation of the access regime, the ACCC came out with draft principles that essentially set the price of unbundled local loop at about $40 per month but it's still about 100 per cent too high, and the actual profit price of

unbundled local loop services should be $20 per month. So what we see as the voluntary commercial negotiation isn't really going to work there and the reason why - - -

PROF SNAPE: What exchange rate are you using there?

MR FRANCIS: We're using PPP, purchasing power parities.

PROF SNAPE: Which are quite a long way away from existing exchange rates at the moment.

MR FRANCIS: Yes.

PROF SNAPE: Now, if you had them at existing exchanges rates, that differential would be much less.

MR FRANCIS: It would be less, but there's all this economic theory that says that purchasing power parity is generally the preferred way to go, but we can - - -

PROF SNAPE: That depends crucially on the question that you're asking.

MR FRANCIS: Yes.

PROF SNAPE: That's the correct answer to some questions and not the correct answer to other questions.

MR FRANCIS: Yes.

PROF SNAPE: So it's a question of what is the question, as to whether that is the correct exchange rate or not.

MR FRANCIS: Yes.

PROF SNAPE: I make the point - and you might want to consider that a little bit more as you tidy up your submissions - but it needs to be specified what is the question before you decide to use existing exchange rates for PPP.

MR FRANCIS: Yes, we'll talk about that. In the Productivity Commission's own paper in 1999 where they were deciding this, they also chose purchasing power parities rather than exchange rates.

PROF SNAPE: And there is an explanation in there as to why, to address the particular questions that were there.

MR FRANCIS: Yes, okay, yes. We'll have a look at that and give you some more on that. Essentially why this is - essentially what we're incurring is a price squeeze

in relation to downstream DSL services. This next slide is also in our submission: this is the price of Telstra's wholesale service for flex stream versus retail prices for its own unbundled local loop offering. So flex stream is the wholesale service that competitors would need to use to supply data services if they were to supply high-speed data to customers using the unbundled local loop, and what we can see is that Telstra's retail price is actually lower than the wholesale price, so it's a classic sort of example of vertical price squeezes.

We heard Paul Paterson talking earlier today about Telstra's internal transfer pricing. I'd be very interested to see the internal transfer pricing on this, because this suggests that Telstra's retail division can produce the downstream service for about negative $40 or something or other to be able to have the same internal transfer price for this. That's essentially also targeting the idea that downstream competitors, no matter how efficient, can't compete in downstream DSL services.

This next one here, which is also in our submission taken from another Productivity Commission report: why do we say retail price controls are the biggest inhibitor of investment? Well, it's for four reasons essentially. The retail price controls hold the price of core infrastructure, a billion dollars below cost according to the ACCC cost modelling, so anyone rolling out infrastructure is immediately faced with having to price consistent with those retail controls and not be able to recoup the price of a basic access.

The second thing you've got is you've got all these subconstraints in retail price controls and they violate the basic principles of good pricing, and that's Ramsey efficient pricing, which essentially says you price inelastic services more highly and elastic services less highly. The actual retail price controls do the exact opposite: they price local calls down - basic access down, which are inelastic - and they price essentially long distance and international services more elastic. There have to be cross-subsidies in the system to meet that.

So in other words, you're talking to a new infrastructure provider and then you say to them, "Right, we're going to create legislative constraints, which mean that you have to price exactly the opposite to what you were doing in a competitive market." That's essentially what the retail price control does. But, thirdly, added to that, just to make sure that we don't get new entry investment, what it also does is it has a broad basket of services which motivates costless predation for Telstra.

Essentially, when new entrants come in and invest, Telstra thinks, "Well, I've lost market share. How do I meet my X in the price cap? I meet it by dropping my prices where I face competition and raising my prices where I don't," and it's a costless thing for them because at the end of the day they don't incur any less profit, so it establishes costless incentives for them to predate. In terms of an entry deterring device, this is quite brilliantly structured.

Then the final thing is that the high X value drives services below cost through

time. We've got in our submission the X value in telecommunications in Australia relative to other countries. At the moment we've got the highest X value in the world, and it doesn't take a genius to work out if you've got high X values you're pushing the price of services down below cost, and if investors can't make returns on investment because prices are held below cost then you deter investment. So this is the key story in terms of why you're not seeing investment in fixed infrastructure in Australia today - it's the retail price controls. What we think, we entirely support the - - -

PROF SNAPE: Can I just stop you on that. The X factor can't of course be looked at separately from the starting prices.

MR FRANCIS: That's right, yes.

PROF SNAPE: So the two need to be looked at together.

MR FRANCIS: Yes, and we say is that part of the starting price is the fact that you've got a billion dollars below cost for access infrastructure, so that would actually suggest a lower X value to get them so you can get them up towards cost recovery, if you're actually starting below cost, so that's that.

Essentially what we say is that it's retail price controls that are inhibiting investment and we support entirely the Productivity Commission's recommendations on removing retail price controls, but we think this needs fuller embellishment in the report, that if you're looking at those key inhibitors of investment and competition in fixed local loop services, it's retail price controls and it's not the access regime, and this is the next point I will go on to.

Fresh data as we speak - this is in our sub as well - this attempts to address whether the access regime as practically implemented could have actually deterred incentives to invest, and what the first slide measures is over Telstra's fixed network you've got Telstra supplying final retail services to consumers and you've got other carriers using it to provide originating and terminating access, and then they do the intercapital transmission, long-distance billing and international termination. What it does is this measures the dollar share of revenues that competitors and Telstra have earned over this network over the last three financial years, and essentially there has been absolutely no change at all. In 1998 there was 91 per cent for Telstra and 9 per cent for competitors; 1999, 90 per cent for Telstra, 10 per cent for competitors, and 2000, 90 per cent for Telstra and 10 per cent for competitors.

So in terms of the relative dollar proportions of selling over Telstra's network, Telstra's share of that hasn't changed and competitors' share of that hasn't changed. Now, if access pricing had been implemented in a way where access prices for access to core infrastructure have been set below cost, we wouldn't actually observe that in the data. What we would observe in the data is that that red part would get significantly larger for two reasons that are in our submission: the first is that you're

distorting the relative price of access versus downstream services, so downstream services become relatively bigger in the proportion and access becomes relatively smaller, so the red would get bigger for that. The second issue is you'd get a whole lot of downstream entry from a whole lot of competitors coming in doing the value-added part in the downstream market. So again you'd expect to see that the red would be getting significantly larger relative to the blue, but that hasn't happened at all. Those two things haven't happened, so that suggests that access prices haven't been set too low for the originating access.

The third point - and this is where again it's inconsistent with the data - is what you'd observe if access prices had been set too low, where subject to the same access processes, you'd observe less facilities based competition over the period, but what you would in fact observe is we've accelerated the roll-out of our network over the period, and I've just got our HFC customer base over that same period and you can see it's gone from 40,000 to 110, 360 and then 500. So essentially we've accelerated the roll-out of own network over this period, and if access prices are genuinely set below cost we'd be doing the renting decision rather than the building decision, but we haven't observed that. So there are basically three reasons why access prices can't have actually been set below cost.

PROF WOODS: Where does that show up in the red? If you've got more customers - - -

MR FRANCIS: Say we get 50 per cent of the downstream market - - -

PROF WOODS: - - - would they not be getting any more of Telstra's revenue? Sorry, the question is if you've got progressively more HFC customers - - -

MR FRANCIS: No, that's not in the red. That's just capturing over Telstra's network, that graph. So that's determining the access price over Telstra's network. Our network will have all blue for that part, but that's not captured in that. What this is capturing is over Telstra's network.

PROF WOODS: Only over Telstra's network.

MR FRANCIS: Only over Telstra's network, which is at the bottom of that thing.

PROF WOODS: Yes.

MR FRANCIS: So what that's saying is, "We've implemented access pricing over Telstra's network. Has there been a larger share of downstream where competitors have come in and grabbed that versus what Telstra has?" The data says there's been no change over three years.

The final thing in terms of ACCC and implementation of access prices is graphed in original submission. Basically we're about 18th in terms of 30, so we're

not actually sort of relatively heroic in terms of the access pricing to infrastructure that we've instituted here. Okay, I've just got one or two more slides. There's one I'll talk to, and this is a bit of a fallacy in the data - a fallacy going around - and that is that there's more facilities based competition in CBD than in metropolitan areas. In fact, our data suggests a bit of a conundrum, that we've observed a lot of facilities based entry in residential areas, and the ACCC costs model actually comes up and says that's the second highest cost area. Our HFC network actually covers metro areas, which is regarded as the second highest cost, and in business areas the data shows that Telstra has only lost about 100,000 lines, whereas in metro areas they've lost about 500,000.

It's a bit of an economic conundrum - why wouldn't you get competitors going in and targeting the low-cost, high-revenue areas first? We think the basic reason for that is Telstra's anticompetitive conduct in terms of not supplying business local number portability and erecting barriers to other carriers going in there and trying to roll out facilities in CBD areas. We'll give you a bit more data on that as well.

The final slide I will go through is that one, 4, which is digitisation of cable networks. Essentially, again, this is addressing chapter 4 of our submission which says that we're becoming a backwater in terms of facilities based competition and investment in new infrastructure, and the digitisation network is zero in Australia, 100 per cent in Italy, et cetera, and what we think is one of the key drivers also is access to open programming that increases the revenue streams and potential of a lot of these new networks. If government facilitates that through open programming arrangements which essentially are - we are not asking for new entrant assistance; what we are asking for is fair and non-discriminatory access to key pay TV programs such as Hollywood movie studios and other things. It is exactly establishing a competitive entry test.

PROF WOODS: Could you clarify whether that's a topic you want to discuss this afternoon?

MR FRANCIS: We will discuss it more prospectively if we can get another speaker in.

PROF WOODS: We will deal with that briefly this afternoon?

MR FRANCIS: Yes.

MR SUCKLING: We need to check whether Adrian is available. He is very busy and it's quite short notice, so we don't know.

PROF WOODS: We will cover it to some extent this afternoon.

MR FRANCIS: In terms of a quick summary of where all of this is taking us, it is essentially in terms of a vision for the future, I guess. Our vision for the future is that

the Productivity Commission in terms of its brief can get rid of government-erected barriers to entry. Those barriers to entry are retail price controls and, at the moment in terms of the practical implementation of the access regime, they don't actually increase barriers to entry. If anything, they're reducing them. If your regulation targets the fixed local loop, which is the only area of significant market failure, then you'll be doing a good job in terms of making the whole of telecommunications fully competitive.

PROF WOODS: Thank you very much. Does that conclude your brief opening comments?

MR FLETCHER: It does, yes.

PROF WOODS: Could I say at the outset that, as I read the material that you've provided or confirmed by way of a final submission to us, as I read some of the phrasing it appeared that there was a very significant difference between the views of the commissioners expressed in the draft report and those of Optus; phrasing such as, "It assumes away the" - "it" the commission's draft report - "structural features that the commission identified in its earlier analysis." What we find there really is that you don't like XIB recommendations, but you're happy with the way we carry through our analysis into our views on XIC.

You use phrasing to the effect that we essentially ignored retail price controls. That seems to translate really as you support our recommendation 10.2 and our view on dispensing with subcaps and in fact support our proposal that Ramsey pricing is an appropriate pricing strategy. You just think we should have gone further into global pricing caps, I assume, and we can explore a bit of that later. There are other examples, but they will do as two. I just make that as a front-end comment. It is a little hard at times to separate the style of the presentation from the substance of the presentation, but we work our way through it.

We may as well go into XIB as the first one and on page 7 you criticise the proposition that section 46 would be sufficiently effective to deal with a number of the anticompetitive issues in the industry. Can you identify for us what you would expect to be ongoing problems you would experience if XIB was repealed? I mean, in concrete terms what sorts of behaviours would you seek come to the fore that are currently inhibited by the threat of XIB descending upon Telstra's head?

PROF SNAPE: If you could do that in the context of noting the recent court decisions with respect to section 46, which of course were not there when the draft report was written nor in the earlier round of hearings and they are of course important decisions and regarded as particularly so by the ACCC - - -

PROF WOODS: Yes, if you could give us some guidance as to how it would be used.

MR FLETCHER: I will make a general comment on that and ask my colleagues to address the specifics. In terms of the specific court cases you mention I am not sure whether we are in a position to address the detail of that at this point but, in general terms, I think the thing we would say about the competition notice provisions is that they have in the past been used to address a wide range of behaviour relating to Telstra network facilities and different products and services provided over those facilities and, in the nature of the telecoms industry, I think it's difficult to predict exactly what new range of services will arise, where we see a flexible rapid response being desirable.

But I think we would make the point that the instances we have pointed to in the past of competition notices being used and being used effectively are varied and we can see a range of areas where we would like to see them being used in the future; indeed in new types of areas like DSL, for example. We think that may very well be a fruitful area, so in general terms the speed and flexibility of an instrument like a competition notice as opposed to a formal court process is one we regard as attractive.

MR SUCKLING: I will just make two points in respect to that. The first is I think that chapter 2 of the commission's report really is an excellent and meticulous outline of the ways in which an incumbent has control and, you know, there is a unique set of features and it identifies things there like the fact that there's these high sunk costs, like the fact that there are high switching costs, particularly in the instance where the incumbent holds most of the customers at the current time and therefore there is not an incentive to make sure you get these transfer processes working because there is absolutely no chance at all that they are going to win more customers than they lose, as you know, so I think, as Paul was saying, there's a myriad of examples around processors such as the local call-local churn resale one, where that could come to the fore as an instance. That's my first point.

My second point, just to build on what Paul said, is that I think you will see very soon in the future an attempt to convince the commission to issue a competition notice in relation to flex stream pricing, which is what Derek put up on the board a while ago. So Derek put up on the board their slide which showed that ULL's prices were at $44 and Telstra's flex stream prices at $78. Product people have provided us with a lot of data to demonstrate that there is simply no way that they can compete with that wholesale price in the market, given Telstra's resale price. I think that is a specific example and if and when we can convince the commission to do this we will provide you with the relevant documentation. That is a specific example where Part XIB will be used likely in the very near future.

PROF SNAPE: But the other part of that was that you couldn't see that section 46 could be used to address that, particularly, as I say, in view of the recent decisions, where Prof Fels was arguing - saying that this was what had been regarded as lawyers as an underlitigated provision in the past but now that they have got a couple of decisions - Boral and Melway in particular - that in fact it would be used - could

be used - by authorities and by private parties much more than in the past. Would that not fit the bill?

MR FRANCIS: Can I make a couple of points on that. One is the relative speed of the actions - and Adam can talk to this, as well, but a section 46 case - and we have got a few of them against Telstra and they take four years to do. Now, in a market such as DSL where essentially that will be rolled out fairly ubiquitously, you would imagine, over the next two or three years. If you're involved in a four-year litigation case you will have missed the market by - - -

PROF SNAPE: But doesn't speed apply equally to both types of errors?

MR FRANCIS: Yes.

PROF SNAPE: It's a speedy process. If you make a mistake it is going to have consequences both ways.

MR FRANCIS: Yes.

PROF SNAPE: It doesn't necessarily mean that you have to execute tomorrow.

MR FLETCHER: Unless you make the assumption that whatever institution you set up is going to go it right more often than they get it wrong you would recommend there be no institutions at all.

PROF SNAPE: The point is that it is probably better to get it right than to get it wrong. If it takes a little bit longer to get it right that's better.

MR FRANCIS: It gets back a little bit to market structure and history but, I mean, essentially with fixed local loop services you've got Telstra with 95 per cent market share and they've got a fair bit of form, and the question is whether you need additional remedies to 46 to deal with that. Now, Part XIB in the past has been used. In terms of the PC analysis, as we understand it, historically there haven't been type 1 errors. There may have been type 2 errors, so historically there haven't been any type 1 errors, and so going forward - the ACCC, we know, don't like to have a non-strike rate, so they're fairly judicious with their use.

The second thing, and this is where it is also - - -

PROF SNAPE: Can I just stop you on that one. I mean, the fact that there may not have been actual type 1 errors does not mean that it hasn't had an effect, a deterrent effect, because the risks are going up. It is not sufficient to say that because the errors have not been made that it has had no effect.

MR FRANCIS: Sorry, we heard Telstra this morning say that Part XIB - they haven't changed their conduct at all because of the existence of Part XIB, so it hasn't

changed their behaviour - - -

PROF SNAPE: You might recall they changed that when we pressed them on it and they admitted that it did.

MR FRANCIS: Okay, so - - -

PROF WOODS: There's evidence in both directions from Telstra and, as we tried to conclude with them, to give some weighting one to the other.

MR FLETCHER: But if it does have a deterrent effect or an effect of causing them to think twice before engaging in behaviour that is anticompetitive where is the evil in that?

PROF SNAPE: Without going right through the arguments that we had this morning it is a question of what are the consequences and, if there are horrendous consequences to taking a particular action, you're going to be perhaps rather more cautious than you would otherwise be about taking that action. That doesn't mean we should have the death penalty for going at 61 kilometres an hour in a 60-kilometre zone.

MR SUCKLING: There are two things quickly to that. One is that there is a way of structuring and investigating these things where you strike the balance between moving with some form of alacrity and getting it right, and I think we would argue strongly that 11 months on the Internet interconnect notice in one of the fastest moving sectors in the economy is about the limit of time you can get, and they got it close to right, and there are equal consequences to getting it right after five years and, that is, by the time you do get some remedy in place and change the behaviour, it is all too late. I suppose that would be the first thing.

The second thing is, on the question of the consequences, there are consequences for competitors and competition of not doing anything at all or moving slowly, so the consequences aren't all just on Telstra, and I think the Internet interconnect is a really good example of that. I mean, Optus faced a situation in which it had started a roll out a backbone infrastructure network. It had partially completed that. It had assumed it was going to get a form of peering with Telstra and Telstra simply refused to do it.

That then called into very real question whether we would continue the roll out of that ATM backbone network, and I think we would argue that if the commission hadn't been able to step in quite quickly and fix it it would have been a deleterious effect on new investments, so I think the consequences run both ways.

PROF WOODS: Can I ask, when you do put in your formal submission that you look carefully at your analysis of type 1 errors. You claim to have a type 1 error, there have to be two institutional errors - that the ACCC must conclude there is

anticompetitive conduct - and indeed it's not - and the court must similarly conclude - - -

PROF SNAPE: There is I think a typo there. I think at the beginning of paragraph 1.11 it should say "type 2 errors occur".

PROF WOODS: Yes, I agree on that, but going back to 1.10, the preceding paragraph, it may be sufficient for the ACCC to conclude there is anticompetitive conduct and then the antideterrent devices within the provision might be sufficient for it then never to be tested in court. I'm not quite sure you actually need both.

MR FRANCIS: But in terms of this if Telstra has got a genuinely legitimate purpose that somehow they haven't been successfully able to enunciate to the ACCC they probably have 50 or so Mallesons lawyers that will be more than happy to explain their case in the court and test that out.

PROF WOODS: Does that mean all court procedures are generally of a known outcome and there is no uncertainty in - - -

MR FRANCIS: No, no, there's always uncertainty.

PROF WOODS: I think that is the point.

MR FRANCIS: Yes, so the ACCC - the issuing of a notice might get them to reform their behaviour.

MR SUCKLING: We take it as a question and we will look at that clearly.

PROF WOODS: Thank you.

MR FLETCHER: I think there is another point to make about competition notices and the distinction between a procedure where the ACCC is involved and one where a court is involved, which is that the ACCC has built up over a number of years now a considerable body of expertise in the telecommunications industry and the economic principles inherent in the industry and it is therefore genuinely able to move more quickly than a court, which has to familiarise itself generally from a very low knowledge base with the economic principles applicable to a particular industry, and we see that as a strong benefit of the competition notice arrangements.

We think that the regulatory structure in Australia which has led to that base of knowledge being built up within the ACCC somewhat painfully over time has now produced a good outcome, which is that you have a body of people within the ACCC who have a considerable knowledge and expertise about the telecoms industry and, I might say, they don't always make decisions our way, but they do have that set of knowledge which enables them to come to grips with specific issues much more quickly than a court would. We see that as an significant additional factor favouring

competition notice processes over section 46 actions.

PROF WOODS: Can I come back to our original question that kicked this one off. We have mentioned flex-stream pricing as one prospective area of pursuit through XIB. Do you have other specific examples you want to draw to our attention?

MR SUCKLING: As I said, it's quite difficult to predict but there is one that Paul is - we're talking with Telstra on a form of data interconnection. Hopefully we'll receive a commercial outcome there, but we can provide in a supplementary submission the sort of details of the issues and problems we're facing there in relation to data interconnection and demonstrate to you how Part XIB could be used to overcome that specific problem as well.

PROF WOODS: How XIB and particularly how it in preference to alternatives?

MR FLETCHER: Yes. We will show you which bits are declared and which bits aren't, and so on.

MR FRANCIS: There are one or two other areas as well where going forward we might be using Part XIB type procedures. I guess a lot of it goes back to the points that we're making, that Telstra's market power is in the fixed local loop, and a good example of that is business local number portability where they're not actually effectively providing it to us at the moment. That's one of the reasons why they've actually lost less market share in business lines than they have in residential lines, even though they're the low cost and potentially the more competitive lines - because they're setting up a whole system of processes that are very similar to the local call resale commercial churn case.

An example is that, if we target any business with over 20 customers, Telstra say, "We can't give them number portability unless we do a pre-porting study," and then they say, "And by the way, we've got no time frames on this pre-porting study, so we're not going to tell you when we've done it. We're not going to tell you when our network's upgraded so that we can give business number portability." So we're left, when we go into a business customer and say, "We'd like to directly connect you," and the business says, "Well, that's fine, but I need to keep my telephone number because that's my business," and we say, "Oh, well, we can't tell you when we can connect your service," and we are made to look like we're somehow a little bit incompetent because of that. It all gets back to Telstra's local loop market power and not establishing good processes for transferring customers to competitors.

MR SUCKLING: We'll take it on notice and provide those and others.

PROF WOODS: There's commonality of view between the commission and Optus about the importance of the local loop and the regulation should focus on the bottleneck. I notice you quote figures on page 22 that Telstra retains 95 per cent of the fixed local loop connections. You run past what, 40 per cent of households?

MR FRANCIS: Yes.

PROF WOODS: I noticed a slide earlier where you'd got yourself to half a million households, but that seems a very slow uptake of an alternate facility. Why does Telstra still have 95 per cent of fixed local loop connections.

MR FLETCHER: I think we would say, in the first place, we'd take issue with the claim that it's a slow rate of uptake. I think we would say that to have achieved 500,000 directly connected customers within this period of time is a very impressive commercial achievement, and compares well to the performance of new entrants in other markets.

PROF WOODS: Particularly for a "small struggling company".

MR FLETCHER: Indeed. It's worth making the point that it involved some $4 billion of investment to get there. Nevertheless, there are significant advantages that Telstra as the incumbent retains, and the struggle to convince people to change from their existing supplier is always a difficult one and involves innovative marketing and sustained effort over the 2.2 million households that the network passes. In many of those households - in fact all of them - they have been through multiple marketing cycles and it is simply a process in many ways of chipping away. I would take issue with your claim that that's a relatively slow rate. I think that's quite a significant rate, and I think Australia is quite well served by its second entrant in terms of the extent of facilities based competition there is in local access telephony. In fact, I think we'd turn those numbers around and say they are a demonstration of the power of an incumbent in this market.

PROF WOODS: I was just reacting to your flavour through the submission, talking about Telstra's virtual stranglehold on the local loop. But, as you say, you've passed 40 per cent and you're progressively building up your customer base.

MR FRANCIS: There are a couple of other points on that as well. Getting back to what we say retail price controls are a key inhibitor because the investment is relatively marginal and they have controls holding the price of key services in a non-Ramsey efficient manner that upsets the efficiency with which you can run that.

PROF WOODS: Your investment's sunk.

MR FRANCIS: Sorry?

PROF WOODS: Your cable investment component is sunk.

MR FRANCIS: The drops aren't sunk into the homes.

PROF WOODS: No.

MR FRANCIS: They cost about a thousand. We can't structure our prices efficiently because of those controls. The second thing is, Telstra didn't provide local number portability to us until 1998, so we couldn't really market the service, and they still don't provide very good local number portability to us in that market. We have to wait a month if we want local number portability because they have installed a fax based paper based service. If you ever ring up and get marketed by the Optus guys they'll say, "If you want to change your number, you can have the service in a week, but if you want to keep your number you have to wait a month or two," and we get a lot of cancellations because of that.

Also building on Paul's point, we do have some of the highest level of directly connected facilities based competition in the world. The take-up is relatively good, but Telstra overbilled our network and they're denying us key access to pay TV programming effectively as well, which is another key inhibitor of take-up because we bundle the services together. So they're government erected barriers and Telstra erected barriers that are the principal cause of low facilities based competition.

PROF SNAPE: I wonder if I could take up a point on XIB. It may be the words rather than the substance in which there's the problem, but I quote you in saying:

> The commission does not demonstrate any economic benefit from having a one size fits all access regime but rather takes on faith a belief that access regime convergence is necessarily a good thing.

I think that it was rather more than on faith. It's not on faith that we would advocate that the same tax system should face all businesses in the country and that the application of it in a particular case might take account of particular circumstances. It's not really on faith. That's on efficient and good policy. It was that same principle that was leading us to say that convergence of an access policy across industries is, in principle, a good thing, so that as far as possible or as far as is efficient you would apply the same principles across industries, so that you don't in fact distort the investment by having different principles of access in different circumstances. That, I think, is rather more than just on faith. Again, it's good policy.

But of course one then has to take account of particular circumstances in the application of it; in other words, one goes as far as is efficient, along with the commonality, and then at the efficient point goes in for a different application. So the discussion, the difference then, is presumably at what point do we branch off to make a different application. So we look for special characteristics which have been identified and which you have mentioned, and it is our judgment that those different characteristics warrant the retention of a telecommunications regime, that it warrants the retention of an XIC, but it doesn't warrant the retention of XIB. Now, that was the logic. It's rather more than faith.

Perhaps the argument wasn't articulated as well as it might have been, I don't know, but I don't think you do justice to the way that the commission was thinking and the logic of its argument by dismissing it in the way that you have. So the question is, are the differences which are identified the real differences, and you agree that they are essentially. We then say, okay, are those real differences sufficient to warrant an XIB. Our judgment was no. I think that in view of the decisions on section 46 recently, that judgment would be strengthened rather than weakened. So I think it's on that basis that it needs to be addressed. I don't think it's quite addressed on that basis in what you've put before us.

MR FRANCIS: On the section 46 and the recent court cases, especially to our mind with a lot of these court cases when you go to the High Court and even the Federal Court in some cases they might infer effects from purpose but in others they won't, and in Melway at the end of the day they didn't infer it. I don't think Melway can be used as supporting justification that there's not much difference between XIB and section 46.

PROF SNAPE: Are you advocating that XIC should be amended so that it should have effects? You in fact argue that 46 should be amended so that it's got effects. You say that XIB is more desirable because it's got effects. The logic of that argument would be that you would be advocating that section 46 be amended to have effects.

MR FLETCHER: I think our position is probably that we assess the various tools that are available to us as a competitor to seek assistance in instances where we believe anticompetitive conduct has occurred, based upon their efficacy in practice, based upon our experience. Our experience, as we've indicated, is that the competition notice provisions have worked well to assist us in obtaining the cessation of particularly egregious instances of anticompetitive behaviour drawn from the rich menu of such instances which Telstra has engaged in and continues to engage in. We haven't, therefore, turned our mind to the question of whether we want to see reform to section 46.

We've asked ourselves the simple question, "Has section 46 or have competition notices been of more assistance to us?" We weigh up the fact that in one section 46 action we have presently on foot - it's been going for four years and will be going for some time yet, with all the attendant cost, inconvenience, involvement of lawyers to a great extent, and so on - and we compare that to the proven success that we've had with competition notices, and we've reached the conclusion that competition notices are to be preferred and ought to remain, and that is the Optus position.

MR WOODS: Just to clarify then, because you do refer to the effects versus the purpose tests, XIB and 46, you'd see a change in 46 to incorporate effects would be a lesser benefit to you than retaining the competition notice regime of XIB. That's your prioritisation.

MR FLETCHER: Yes, we certainly would. I'll ask Derek to comment on the details, but in the first instance, the advantage of the competition notice provision is speed and the industry expertise of the people who are making the judgment. But, secondly, even having regard to the most recent set of cases, we remain sceptical about whether section 46 actually gives the right outcome in terms of effects versus purposes.

MR FRANCIS: The only thing I would say is, we don't necessarily care that much how you get there, so long as there's an effects based test in the act to deal with Telstra's anticompetitive conduct, so that you don't necessarily need to rely on the sort of merry-go-round of the court cases to infer purpose when sometimes it doesn't actually happen that purpose is inferred. So at the end of the day we don't care how you get there, but an effects based test is a desirable economic test to have there and it's an especially desirable test when you've got one player with 95 per cent market power and the effects based test has been used against them successfully for the last four years.

PROF SNAPE: 95 per cent of the market - - -

MR FRANCIS: Of the market for fixed loop.

PROF SNAPE: - - - is not market power. I mean you've already said that you pass 40 per cent of the households, which must be a very significant constraint upon market power. They've got 95 per cent of the market.

MR FRANCIS: They've got 95 per cent of the market. At the moment we can have the infrastructure, but we've still got to get the customers across, and until they switch them across to us we're still constrained by the fact that they've got the customers. We can have as much network as we want.

PROF WOODS: Can I just clarify back between your answer then and Mr Fletcher's answer though - that because the competition notice regime is a separate issue, to an extent, than the effects versus purpose. Can I just ask once more: is it the competition notice regime that's the more important feature - - -

MR FLETCHER: Yes.

PROF WOODS: - - - rather than the effects versus purpose?

MR FLETCHER: Our starting point is that any inconsistency between Mr Francis and myself is apparent and not real.

PROF WOODS: Absolutely.

MR FLETCHER: The second point that I'd make is, as Derek said, ultimately we

don't particularly care how you get to the result. If you genuinely could overcome the difficulties with section 46 that would be tremendous. We're sceptical as to whether you could, but secondly we do believe that there are institutional advantages to the present arrangements.

PROF WOODS: Okay, that's what I thought you were saying. You promote the concept of substantial market power test, which was just being alluded to by my good colleague. Do you have a definition of it? You mentioned the European Community and they use certainly a percentage of customers or other variation. Would any of definition of it that you put forward automatically exclude your HFC roll-out or is there some version of a substantial market power test that might in fact include it?

MR FLETCHER: I think we would be inclined to specify the test in those terms and then let a court ultimately decide what it means, and no, we definitely don't rule out that Optus might be held to have substantial market power in a range of markets in which we operate. As it happens, we would argue that on the present factual circumstances in almost all markets we don't have that power.

PROF WOODS: All markets that we're focusing on here?

MR FLETCHER: Yes.

PROF WOODS: Putting aside mobile.

MR FLETCHER: Yes. I was just going to come to mobile, where clearly we would acknowledge that we do. However, in the markets that are being focused on here, we would say at the present we don't believe that we would but we wouldn't see a need to specify a formula or a percentage in legislation. We see that as something that would appropriately be determined by the relevant body.

PROF WOODS: Just while we're dealing with your HFC, you put up an interesting table of digitisation of broadband networks and had Australia as zilch. What is the business plan for Optus for digitising the HFC cable?

MR FLETCHER: We have indicated publicly that a full program of digitisation which would include upgrading all sector boxes to digital, which is a critical element, is not something that is presently within the immediate plans of Optus. On the other hand there is presently a trial which will shortly be commenced of digital interactive television, which will involve some 300 households on the North Shore of Sydney, so it's clearly an area that we are looking at carefully and we believe that the future will involve the provision of these kinds of services to households, and we also believe that cable television networks are far and away the best way to deliver digital television as compared to free-to-air or satellite.

Another complicating factor clearly is that the ownership of Optus is likely to

change shortly, and the decision as to the future business activities conducted over the HFC cable is one that we would anticipate the new major shareholder would want to review. I think that's as much as can be said at the moment. We're clearly watching it carefully. It's clearly on a menu of real possibilities for the company. Are we ready to press the button yet? No, we're not.

One last point I would make is that in a sense to say is the network digital or not is a simplification. Almost every element of the Optus HFC network is presently digital. We are, however, not in a position to provide end-to-end digital services to customers yet.

PROF WOODS: No, I was shorthanding the conversation. It's just that if we explored, as we did this morning with Telstra, what are the impediments to digitisation in its simple construct, how much of it is uncertainty of technical innovation, how much of it is customer uptake, how much of it is behaviour of competitors and how much of it is regulatory uncertainty as to access by others to that facility, where does the regulatory uncertainty sit in that broad menu? How important is it and how could it be overcome?

MR FLETCHER: The Optus position is quite different from Telstra's position on this issue. We have had for some years a stated policy in relation to our HFC network of open access. That is to say we regard ourselves as the operators of a pipe and we are happy to sell capacity on that pipe to people who can put a proposition to us that is commercially attractive. Presently, the analog television capacity on the Optus HFC cable is used up, as is the case, we understand, for Telstra and Foxtel.

Clearly if the network were to be digitised you go to a world where you can have several hundred channels. It depends which guru you speak to as to exactly how many but you can certainly have several hundred channels on the HFC network. In that environment we would certainly anticipate that we would be doing deals with people to carry content other than Optus television over the network. So we do take a different view to Telstra based upon what is reported about Telstra's attitude and Foxtel's attitude. It appears that Telstra and Foxtel regard the prospect of regulatory intervention as something that is fundamentally unattractive and is a significant impediment to digitising the Telstra network.

In the Optus case clearly we would focus with acute interest on the precise details of the regulatory provisions as they would apply. However, given that our principle is we expect to be doing deals with people that have content that we want to carry or services that we want to carry, a regulatory outcome that got to the same position, namely, we charged people for carrying their services on our network, is not something that causes us to whiten as it evidently does our competitors.

PROF WOODS: Why is there this different perspective between two organisations who both have cable rolling past several million households?

MR FLETCHER: I think ultimately all we can do, in answer to that question, is to speculate and offer some theories, but certainly one theory we would offer is that because of the ownership nature of Foxtel and the reported different interests of the different parties, Telstra and Foxtel are not as well advanced as Optus are in offering an integrated bundle of services, and in offering customers the opportunity to take, for example, telephony, cable, modem, television in different ways and in different combinations. In other words, to do all the things that the HFC cable has been promised to be able to do for some years.

Because we are more interested in doing that I think it's a better fit with that strategy to say, "By the way, not only can we offer you a combination of services that we produce, but we also have the following additional services that are provided over the network by other people and here's a basis on which you can acquire those services as well."

PROF WOODS: You make reference to combination of services. Is it in fact a strategy of only offering bundled service access to your cable? I mean, you mentioned before that you consider yourself the owner of a pipe. As the owner of a pipe, any sale, provided it met certain minimum levels, is a good sale and therefore bundling wouldn't necessarily have a priority. But is your retail strategy to only offer bundled services?

MR FLETCHER: Our retail strategy certainly has a strong focus on bundled services. Do we have customers who only take telephony or paid television or the cable modem? Yes, we do. In our annual results last week though we announced that the percentage of new customers joining the network who are taking multiple services is - I think it's around 40 per cent. We can check those numbers and get them to you, but we have announced that a high percentage of people and an increasingly high percentage of new customers are taking bundled services. So I guess I would qualify my comment that says we believe we're the owner of a pipe by saying we believe also that as a company we have considerable and growing expertise in how you best configure the various services that can be offered over that pipe to be attractive to consumers.

PROF WOODS: I am just wondering if Optus is also having some difficulty within its organisation of identifying what is its wholesale business and how it would have open access to its facilities versus being a service provider at the retail end, and whether there is some level of strategic separation within Optus on those two issues or whether you're vertically integrated and behave in similar ways to another vertically integrated entity.

MR FLETCHER: I think the answer to that question is to date it has been a relatively theoretical question in part because we don't have anything like the market reach of Telstra and therefore we don't tend to have as many people coming to knock on our door, but the managing director of our consumer multimedia division, Adrian Chamberlain, has made it clear publicly on a number of occasions that he sees a

strategy which involves us carrying other people's services, and we would expect - again making the point that's dependent upon digitisation, but we would expect, therefore, to configure our business appropriately.

I would make the point that across other aspects of Optus's business, we have shown a greater enthusiasm for various aspects of wholesale business that Telstra has, and perhaps the best example of that is the deals that we have done to resell large parts of our backbone optical fibre network to players like AAPT and Primus, and the kinds of deals that Optus has done in that area are significantly more advanced than the kinds of deals that Telstra has done in that Optus has been willing to essentially sell designated fibres of the bundle of 36 fibres for a considerable number of years. It seems to be the case around the world, that second players, second entrants, are genuinely readier to do those kind of deals than incumbents, and Australia has been no different.

MR SUCKLING: It is worth adding just on that one, if you look at the AAPT deal, for example, which supports this proposition that Paul is making - I think there's a quite good quote from Larry Williams, who was the then CEO of AAPT, who points out that the cost at which they got access to fibre over a 25-year period is substantially below the costs of rolling out their own network and they were therefore very happy with it and thought that it would assist them to compete in the long distance market quite effectively. There is a quote from him that we can supply to you, if you want.

MR FRANCIS: There is one other point I just want to make - this is going back a little bit as well - with the digitisation, and Adrian will make this point more directly tomorrow - and that is that I guess a key barrier that is dulling our investments is lack of open access to key programming. Obviously if you have a lot more decent channels to show, then the incentive to actually upgrade that capacity will be enhanced. We actually say that that lack of access and the program exclusivity that is practised at the moment is a key barrier that is getting in the way of our incentives to invest and upgrade.

PROF WOODS: Just while we are talking about structural separation and accounting separation and the like, you make a comment on page 16 that the commission should recognise that Telstra is subject to some of the most light-handed structural regulation in the world, and the parliament made up for this fact with Part XIB. If I can pick up this issue of separation and talk about accounting separation that Telstra outlined in its first hearings before us and then again today, as an industry participant, how would you rate the transparency that was put forward today regarding Telstra's wholesale and retail activities?

MR SUCKLING: I think it's something of a chimera, the way that we would represent it. You would know that the commission has been involved in a series of arbitrations, many of which are arbitrations by access seekers seeking access to Telstra's network. Many of those arbitrations revolve around the question of what is

the cost of access to that network. My experience in three years of these different arbitrations is it's like a game of bluff; you simply don't know what the costs of Telstra running its network are. When you seek to get the true costs of running that network or indeed any internal documentation that may give you a hint as to them, you get a lot of letters talking about commercial-in-confidence and simply refusing to give you access to that information.

So I don't think there's really any evidence in the last three years to demonstrate - or even recent evidence - that that structural separation and accounting separation is in place to a degree that the industry could rely upon to set prices that they would think are comparable to the prices that Telstra charges itself.

MR FRANCIS: If I can give some practical examples, I can assure you their own retail divisions don't face the prices that Telstra proposes to us at wholesale level, because if they do it wouldn't be observing their own retail prices. A classic example is a local call resale, where at the wholesale level they want to charge us about 25 or 28 cents per call. Now, if they're charging their own retail division that, I don't see how they can be striking 15 and 18 cent prices. They've put in to the ACCC to get in all these exemptions so they don't have to actually provide it to us. And then the second thing is, on unbundled local loop services they are trying to price it to us at a hundred bucks, where their own retail division is at $70, so I don't see how they can possibly be doing that.

So essentially the name of the game is that their modus operandi is construct a deal that competitors can't compete with and then get NECG to go down to the commission and try and justify that with some economic hyperbole and, as Adam said, it's just a chimera.

PROF SNAPE: Can I just pick up the same sentence and read it again.

> The commission should recognise Telstra as subject to some of the most light-handed structural regulation in the world, and parliament made up for this fact with Part XIB.

MR FRANCIS: Yes.

PROF SNAPE: We've had this stated on a few occasions but we haven't even seen any evidence for it.

MR FRANCIS: The evidence is in our submission. The other countries - one, you've had a line of business restrictions on the local telephone incumbent rolling out cable networks, so if you put that on Telstra we'd be more than happy.

PROF SNAPE: The point was the second half of the sentence, that parliament made up for it with Part XIB.

MR FRANCIS: Okay.

PROF SNAPE: That's what we have been told a number of times and haven't seen any actual evidence. Is that supposition or is that hard fact?

MR SUCKLING: I wrote that so I may as well justify it. I think that the point that we're trying to make there - and that is in parenthesis, you'll notice. The point we're trying to make is that in other jurisdictions there is a mix of both behavioural and structural regulation and, as Derek was saying, our contention is that one of the things that the commission does in its report is to say behavioural regulation is not relied upon nearly as much now the jurisdiction is here, and our fundamental point is that you need to look at behavioural regulation in those other jurisdictions in the context of the mixture of behavioural and structural regulation that they have, so that the points we make are - you know, obviously in the United States there is structural separation between the local loop and long distance.

In the UK - going back to Don Cruickshank's days - there's quite rigorous accounting separation which is used to set interconnect rates, and then in gas and electricity in Australia there are quite rigorous structural separations in place. So I guess really our point is simply to say that jurisdictions make something of a trade-off between structural and behavioural regulation, and we would argue that a reason for Part XIB is because the structural separation here is not as onerous as in other jurisdictions.

MR FRANCIS: One other point: in the UK they actually have something much more than Part XIB, which is essentially a "stop doing" power. In the UK OFTEL essentially uses licence conditions as a "do something" power, so when competitors go and complain about competitive conduct, OFTEL then puts a licence condition on BT which says, "You have to do this to remedy your anticompetitive conduct." So it's a far stronger regime than the regime we have here. And in the US they have full structural separation of local and long distance and they had full structural separation between the cable companies and the telephone companies until 96, a far more competitive regime than we have here, and far better facilities based competition because of it.

PROF SNAPE: This then is your interpretation of what parliament did, not the fact that parliament said that.

MR SUCKLING: Point taken, yes.

MR FRANCIS: We do put a lot of effort into writing our submissions in a lively and entertaining style.

PROF WOODS: Let's move on, and perhaps we can get to some closer agreement. The replacement of the LTIE test with economic efficiency - it's interesting, your phrasing of that first sentence in 2.6:

> Optus agrees with the commission's proposals to replace the LTIE with an economic efficiency test -

our words -

> that attempts to maximise social welfare -

your phrasing. Would "economic welfare" have a better meaning than an "economic efficiency"? Do you have any preference between those?

MR FRANCIS: Probably. It's probably slightly broader than the pure pursuit of economic efficiency, but maybe they're the same.

PROF WOODS: You might want to reflect on it and give us your view.

MR FRANCIS: Essentially that's why we're all here at the end of the day.

PROF WOODS: Of course. You refer to access holidays with respective marginal and contestable investments and support the granting of access holidays. We had a discussion this morning with Telstra about safe harbour proposals. Do you feel the need to extend or develop further the proposals we had? You have some treatment, albeit brief, in the material in front of us, but would a safe harbour proposal be more rigorous and of greater benefit to industry, or are the access holidays, as we proposed, sufficient?

MR SUCKLING: It sort of comes back a bit, I think, to - you know, if you get the first test right, theoretically, and you only declare things which are essential to competition, in theory you wouldn't need the second exemption. But I suppose you'd never know totally how things will be interpreted, and we've an argument to you that we think that the ACCC did interpret the LTIE test a little broadly, say in respect of intercapital city transmission, and so I guess we have argued in favour of some form of safe harbour - sorry, access holiday for new investment.

PROF WOODS: Talking of the tests, you refer to our second, third and fourth tests as being onerous for declaration purposes. You then speculate that perhaps the ULL may not pass that test and have some brief discussion on that, line sharing services and local call resale. What changes to wording would you proffer to the commission that would correct what you see as perhaps deficiencies in the phrasing of our declaration criteria?

MR FRANCIS: I guess we agree with the actual decompartmentalisation into the originating and terminating, but we would probably even draw it more narrowly to originating and terminating fixed local loop services, and for that essentially what we'd just say is have a substantial market power test there and don't have various of the other ones, such as significance to the national economy, no substitute services

available, competition in downstream markets, et cetera, because essentially why you have gradual facilities based competition - facilities based competition is not here and now, it's not significant, but what we'd worry about is that if all of those tests had to be satisfied you'd get a winding back of your market regulation in single areas where there is market failure such as unbundled local loop services and local call resale. So keep the test relatively simple and just have a substantial market power test there.

I guess for services that are not originating and terminating, probably the regime you're suggesting is fairly reasonable. I'd make one comment to the effect that test 3, the competition in downstream markets, is insufficient. I've talked to Ralph about this. I don't think that's a particularly desirable test because essentially if you have an upstream monopoly, downstream competitors can't constrain that upstream monopoly and you'll still get your monopoly inefficiency and your inefficiency in your factor pricing, so I would probably delete that test 3 for those services. But for the services that are non-originating and terminating, in general you can set the test significantly higher, because that doesn't pertain to the areas where there is market failure in general.

MR SUCKLING: Yes, but I think also, as you'd be aware, this paper that we've provided the commission is a first pass at it of our views, and you've got detailed questions and we're absolutely aware that you've got questions which say, "If you were to adopt this test as opposed to the one we're suggesting how would you rephrase the wording?" and so on. Now, we propose to - - -

PROF WOODS: You would respond.

MR SUCKLING: Yes.

PROF WOODS: But that would be helpful to us. As I've mentioned previously in these hearings, we don't take on the role of the Office of Parliamentary Counsel but we do want to give as clear guidance as possible and we are very keen to get the practical testing of our words as constructed from those who are in the marketplace, so that you can look at it and explore the nuances and offer advice, so we are very keen to receive your input.

PROF SNAPE: I would say what we did this morning, too - that we of course have a number of inquiries in parallel - one of them not quite in parallel, it's lagging the other ones - it's airports. Insofar as we've drawn upon the principles in the access inquiry, if you have thoughts about how they might go across into other areas, that would be helpful.

PROF WOODS: And if you could give some priority to that line of thinking and respond to the commission, we would appreciate it.

MR FRANCIS: Just on that, getting back to that sort of vision statement as well, a

lot of the vision I think is the retail price controls that are the key inhibitors and we wouldn't want that to be lost in the minutiae of the particular wording for the declaration criteria.

PROF WOODS: That's what I was about to get to, looking at 237. Is there anything more you want to deal with on the access regime?

PROF SNAPE: I was just going to respond to that one. I agree in principle with what you just said. On the other hand, I think the wording in this case, in the access criteria, particularly as we are trying to make it generic, except for the first two points which of course apply to Telecom specifically - that the wording is pretty important in this case - to try and get the wording right - - -

MR FRANCIS: Yes.

PROF SNAPE: - - - because it is something which we are attempting to carry across a number of areas.

PROF WOODS: You go into some considerable depth on the issue of retail price control, spanning quite a number of sections, and are somewhat critical of the commission for failing to deal with it, as it would appear from reading, whereas that perhaps we've failed to deal with it in the depth that you think it warrants might be a better exposition of the situation.

MR FRANCIS: Yes.

PROF WOODS: We have a recommendation which gives support to subcaps being repealed. We talk about Ramsey pricing and try and include that in our access pricing principles. Both of those one assumes you give full support to. Could you try and encapsulate then the direction of your argument in relation to retail price controls more broadly? Are you looking at the global price caps? If so, perhaps if you could give a simple way through this argument that you've included in this written material, it might help me.

MR FRANCIS: I guess essentially the whole of access price in Part XIC can only be understood in the context of retail price control. There is not a single access price that hasn't been set where the retail price controls haven't completely perverted and distorted the outcome. The examples are interconnection, which is our basic service for supplying long distance - 50 per cent of that is an access deficit contribution caused by the low-cost price in basic access. Local resale - essentially the arguments are there as to whether Telstra gets a local services deficit, and then again we get above-cost pricing.

I guess our big problem is that if all of this debate on Part XIC takes place in an intellectual vacuum that doesn't acknowledge the perverting effects of retail price controls, then you move from a world of second best to a world even worse than the

world of second best if you attempt to institute first-best principles, given that retail price controls exist. The points that we make in the final submission that you'll be getting is that if you have legislative pricing principles in the context where the price control recommendations don't get up, then you'll actually potentially worsen the outcome versus allowing the regulator to have greater discretion.

The example that's given is if retail price controls cause below-cost pricing, then you can't have a legislative pricing principle that says access pricing principles have to provide for full cost recovery for the infrastructure provider, because then you've immediately violated the ECP rule, so you don't provide for any downstream entry or downstream competition.

Essentially what we say is, you've spent three chapters analysing access pricing, et cetera, and that's all very well and good but at the end of the day the key inhibitors of investment facilities based competition are retail price controls - you'll probably agreement on that from us and Telstra - and the whole discussion can only occur within the context of the retail price controls, and those distortions to investment and competition would occur because of it.

PROF WOODS: There still are two issues, aren't there. I fully understand the contribution that retail price controls make to the final price that is determined, and the distortions that that creates, but there is separately then the question of what are appropriate pricing principles. I guess my concern with the draft material that we have before us is that you pursue the distortions of retail price controls so completely and fully that the second question of what are appropriate pricing principles gets lost in the dialogue that's there.

MR FRANCIS: This is what's appropriate legislative pricing principles?

PROF WOODS: Yes.

MR FRANCIS: Essentially what we say is that you can't necessarily have legislative pricing principles in the context of retail price controls if they're continued, because you are in the world of second best where you can't actually satisfy your first-best principles in the legislative pricing principles. You'll make matters worse if your legislative pricing principles get up in the context of current retail price controls.

PROF WOODS: I understand some of that interaction and that is certainly worth developing in our final report but, given that interaction, the result of the approach that you are taking would be that you live with the uncertainty of non-legislative pricing policies at the mercy, one could see, of the regulator, so that you've got less certainty and yet certainty is a theme that you've developed elsewhere in your submission.

MR SUCKLING: Sure. I think what we'd say to that, though, is that we'd make

the first point that Derek has made, then we'd go on to say that if - I think the commission, from memory, talked about TSLRIC: "Is this sort of thing you'd embody in the legislation as shown, and would it provide certainty?" Well, in a sense it would, but in a sense it would be a false victory because even if you enshrined the principles in legislation - you know, the ACCC have pricing principles - you're suggesting it should go into legislation. That's good, but the problem is that really the ultimate outcome at the end, the ultimate price that you pay, partly depends on the methodology that you adopt, but it very, very substantially depends on the application of that methodology and the understanding of it.

If you look, for example, at TSLRIC, that's fine in principle but you only have to look at Telstra's ACT appeal to see that there are about 40 or 50 different variables that impact on that. So I think the question of certainty around principles needs to be looked at in the context of the application as well.

PROF WOODS: The principles we're referring to are those included in our draft recommendation at 10.1.

MR FLETCHER: I suppose we're partly making the point that really one of the principles you ought to have is that there shouldn't be regulatory processes coming from elsewhere, in this case the price caps which tend to subvert the operation of the other principles.

MR FRANCIS: I guess there are just one or two other points as well, probably - it's the interdependent nature of the actual recommendations - I think I said this at the other speech - at the moment where you've got the access regime extending probably too far into competitive services, these legislative and pricing principles might not do much good there, so if you get a narrowing of the declaration test, then they might have sufficient focus. Secondly - and I get back to this as well - if you asked us whether we'd prefer uncertainty to first-best pricing principles in a world where we have second-best and retail price controls, our answer is no, we don't want that because it makes outcomes even worse in terms of economic efficiency if you attempt to apply first-best principles in a second-best world. It all gets back to retail price controls.

PROF SNAPE: I find it difficult to see that the principles in 10.1 are not principles that would carry over into a second-best world as well as a first-best world.

MR FRANCIS: Correct me if I'm wrong, but there are two principles that you actually can't simultaneously satisfy in a second-best world, and that is that the access price has to provide for something such as full cost recovery or legitimate cost recovery. The second one is the imputation role.

PROF SNAPE: Is what?

MR FRANCIS: You have to permit downstream efficient entry. If you have a

retail price control that holds the retail price of a service below cost, then you can't have a wholesale price that (1) provides full cost recovery for the facility owner and (2) permits efficient downstream entry for more efficient downstream providers. You can't actually satisfy both of those principles.

PROF SNAPE: I'm looking at draft recommendation 10.1.

MR FRANCIS: Yes, so it's generate revenues across facilities, regulate the service of - at least sufficient to meet lower and efficient costs. If you've got a retail price control that holds the price of services below cost, then an access price that's set to recover cost means that the downstream activity - you won't get any efficient entry because you violate the ECPR rule. That's the one that we're in.

PROF SNAPE: Yes, but if you have the retail price controls that lead to an access deficit and they're not removed, what pricing principle would you have?

MR FRANCIS: Sorry, if you remove the retail price control?

PROF SNAPE: No, if you don't remove the retail - because they're a fixture.

MR FRANCIS: In the world of second best you do need regulatory discretion to take account of the world of second best. That's what we say.

PROF SNAPE: Yes, but I'm just trying to say what pricing would you advocate in those circumstances?

MR FRANCIS: In that particular circumstance you probably do need a price that at least is permissive of downstream entry, so retail less avoidable costs. You're never going to get proper facilities-based competition in that circumstance because you've got the retail price control holding the price of the infrastructure below cost.

PROF SNAPE: I understand that. I'm just trying to think of what is - given that - - -

MR FRANCIS: At least you get downstream efficient entry if you have the wholesale price set at retail minus avoidable costs.

PROF SNAPE: You may not have any facility if you do that. I'm sure you'd make a loss on the upstream as well as on the downstream.

MR FRANCIS: They already make a loss on the upstream if the retail control holds it below cost.

PROF SNAPE: Well, think more about that.

MR FRANCIS: Yes.

PROF SNAPE: Okay, anything more on pricing? No.

PROF WOODS: All right, if we can deal briefly on pay TV, given that we may get the benefit of further information at a later day, you have in 4.15 a statement that:

> Telstra-Foxtel business strategy is not focused on giving customers more for less. Their core business strategy is making other networks less competitive by denying such networks access to key programming.

Are you extending this view to not only Optus but to other providers of network facilities, maybe Neighbourhood Cable or Transact or others, as well? Is this a general comment that you're making or is it one born of particular experience in Optus' case?

MR FLETCHER: Our understanding is that the difficulty that we have had when we have attempted to purchase programming to be carried over our network and have been met with the objection that the programming cannot be provided to us because that is not acceptable to Foxtel, is a difficulty that has been met by other operators.

PROF WOODS: You say that it is making other networks less competitive. Are you saying this is the reason for Foxtel's behaviour - is to in some way protect the owner of the pipes and conduits?

MR FLETCHER: Our view is that prima facie one would expect that the owner of content would find it attractive to sell it to as many cable television platform operators as possible, given that remuneration in the industry is typically on a per subscriber per month basis. If there's a refusal to do that, one can infer from that refusal a reason for it, and the reason that we infer is that there's a desire to make life difficult for other pay television platform operations.

PROF WOODS: And not just pay television platform but that would extend to cable generally, which might carry telephony.

MR FLETCHER: Exactly, yes.

MR FRANCIS: Essentially what's occurring in Australia - and this is the flavour of the submission - is a bit of an inferior and self-defeating competitive dynamic. It's not necessarily focused on innovation and providing new services and packaging and bundling, et cetera, it's focused on locking up key programming and denying competitive platforms access to that. It's not really something that's observed elsewhere and it's not really very economically efficient, because essentially you're trying to frustrate the wider distribution of that content to people that want to view it. Essentially it decreases the productivity of all these new facilities-based investments. This is why you can institute very, very mild micro-economic reforms and you can actually generate a lot of facilities based competition from such reforms.

PROF WOODS: We'll pursue that, I think, on a later date, given that you want to reconsider or develop further your views on universal service arrangements.

PROF SNAPE: Could I just get one point. The opening statement that you made that the content owner would try to maximise the audience since the typical manner in which it is sold is on a per audience basis - it may not necessarily be on a fixed price per audience, might it? I mean, there's a price variable as well as a quantity variable in there.

MR FLETCHER: It depends upon the institutional arrangements in the industry. The point I'm making is that based upon the Optus television experience of the industry, pricing is typically on a subscriber per month basis. There is sometimes some stepped arrangements so that pricing goes up or sometimes down, depending upon reaching minimum subscriber thresholds.

PROF SNAPE: No, my point was simply that if I am a monopolist and I can own something which is valuable, then I won't necessarily try to sell it to the maximum number of people.

MR FLETCHER: No, indeed.

PROF SNAPE: I will in fact be looking at the prices variable within that, so similarly in selling it to you to onsell, there may be a gain to me if in fact you limit the market so it was not necessarily maximising the audience as the profit maximising behaviour for me.

MR FLETCHER: No, indeed. You may seek to use your market power in a way that is not consistent with overall consumer welfare.

PROF SNAPE: So the starting point that you had there of saying that a content owner will seek to get as many people watching as possible is not necessarily so.

MR FLETCHER: No, it's not, but I would stand by my statement that you could infer from there a demonstrated refusal to do that - no motive.

PROF WOODS: Your section 6 I think there's very little between your views and that expressed in the commission's draft report that warrants time at today's hearing, but do you want to pursue the question of digital, Prof Snape?

PROF SNAPE: I am invited to wind myself up into vision mode again. At least some of you heard what I said about a vision this morning and how some parties have criticised our draft report of not having a vision of where things could go in this convergent world. We're not sure, of course, what technologies will come up, what will emerge, but nor were we in the broadcasting report trying to say, "We're going to converge one way or another." Let's try to remove as many barriers to the

development of this new world and open up as many possibilities as we can.

Telecoms are very complex in many areas and you have been discussing a number of them, so let's try to get above the level of the detailed interstices of it and let's get right up into the vision thing. Would you like to try and do that? The first thing you're going say, I assume, is that the major barrier is the retail price control. Okay, we've got that one, so take it as granted that you've said that, and let's think about the exciting world that we should be entering - broadband technologies and everything else. What is it that will inhibit the development of this exciting world?

MR FLETCHER: I think to do that question justice we would prefer to take it away and think about it and come back to you with a serious written response.

PROF SNAPE: We would much appreciate that, and if we get those serious responses to that, then perhaps we can develop our own approach rather more in that direction.

PROF WOODS: You mentioned a prospective new owner in several of your answers. Are you able to outline their views on the appropriate scope of regulation as it should apply in Australia?

MR FLETCHER: I don't think there's much that we can say about that in any detail. In the area of the regulatory programs of the two companies, as in all of their other activities, we've taken the view that until such time as a change of control actually occurs and Singtel becomes the majority owner of Optus, there are limits on what is appropriate and proper to do in terms of engagement because it is not a fait accompli, although it is certainly a likelihood. I think I would just make the comment that Singtel have stated publicly they believe that one of the attractions of Optus is that they can learn from Optus's experience in operating as the second player in a market, as compared to their own experience as an incumbent, and I would certainly anticipate that part of what they would seek to learn is how to operate under a regulatory regime and what features of a regulatory regime serve to assist competition and what serve to impede competition.

PROF WOODS: Are there any other matters you wish to put before the commission at this hearing?

MR FLETCHER: Not at this time.

PROF WOODS: Thank you very much for your considered answers to our questions and we look forward to a formal submission and the development of some of the matters that we have identified and that you have offered to provide additional material for. I will call a brief break and then we will resume today's hearings.

PROF WOODS: We resume for the final session this evening. We have AAPT as participants to the hearing. If you could please identify yourselves and the positions that you hold?

MR HAVYATT: I am David Havyatt, regulatory director at AAPT Ltd.

MR HUGHES: Paul Hughes, partner of Freehills.

MR HOWARTH: David Howarth, a solicitor at Freehills.

PROF WOODS: Thank you very much. Do you have an opening comment you wish to make.

MR HAVYATT: Just a very brief one, thank you, commissioner. First of all, we also welcome the opportunity to present today. The commission has done an extremely detailed job of analysing and reviewing the telecommunications specific regime and I am not sure that in any short brief submission one can do justice to the comprehensive report. The first thing that we do want to note though is the two conclusions that we see the commission having reached, and that is competition is not yet mature in telecommunications, and also there is no evidence that the regime has led to a reduction in investment. In addition, we welcome the principal conclusion that there is an ongoing need for telecommunications specific regulation which follows from the conclusion that competition is not yet mature.

Where AAPT is somewhat uncertain is in the commission's desire to unify this regime with the generic access regime as this runs the risk of undermining the benefits of specificity. Most of the submissions to this inquiry by nature have focused on the participants' perceptions as witnesses of the regime, and sitting through the hearings and reading the submissions, one would almost conclude that telecommunications has not progressed in the last four years in Australia. I think this distorts the fact that the regime is working, albeit slowly, and we have seen the development of a degree of competition in this market.

You have identified the role of lawyers, and here I am flanked by two lawyers. Senator Alston also last Wednesday, speaking at ATUG, flagged the role of lawyers, and the bottom line is it is right for people to utilise the regime as it is constructed, and we cannot criticise anybody for utilising their legal rights to the limit that they exist. The problem that that creates for us in the current inquiry is the expectation of what will happen when there is change. As the regime changes that creates opportunities for a whole new set of behaviours, a whole new set of legal manoeuvrings by participants in the industry.

One of the questions that I think is particularly important for the inquiry is whether the timing of the change or any proposed changes in fact produces more opportunities for manoeuvring than any benefit that may come from the introduction

of those changes. Before I go on and comment on the details, one of the elements that is important to pay attention to is the industry structure in Australia as opposed to the industry structures that may exist elsewhere in the world. We have got a fairly unique structure in the sense that in the European market you've got a number of neighbouring incumbent operators where there is a great deal of cross-entry. You have got certainly the incentive for parties to both work on the way the regime may work to their benefit.

Similarly in the US you had large, powerful, local monopolies dealing with large, powerful, long distance operators, and then the emergence of each of those wanting to enter the other markets. Australia does not have those characteristics. As much as Telstra might like in its submissions to characterise itself as the poor little Aussie battler fighting large telcos coming from overseas to steal their market, I think the evidence of course is completely and utterly the other way. The evidence can only relate to the operation of this market. Entrance investments relate only to this market, not their capital adequacy elsewhere, and in this market we do not have any circumstances in which Telstra, as far as we can see, is an access seeker except for some termination cases.

That's where I would then launch into what our vision is. Our vision, in short, is that one of these days Telstra will be an access seeker; we will no longer have an industry predominantly made up of one owner of infrastructure, nor in fact that all participants in the industry will see the need to be vertically integrated or that other people will see the need for them to be vertically integrated. Our vision is in an industry in fact of a number of players, each of whom will be operating at various levels of the market with some infrastructure and some retail services, and actually have a vibrant wholesale market in which participants are buying and selling aspects of their service from each other.

In that kind of environment you will also see a recognition of the distinction between what I typify as the OEM market and the wholesale market, which is the difficulty I see with Telstra's own conversations about how their accounting separation will operate. As far as I can see, their own version of that separation is that they intend to own the operator at the wholesale level of that, and still never give to their retail divisions visibility of what I call the OEM component. The OEM component is things like terminating access as opposed to complete resale of a local call.

Equally, the question has been raised about certainty a number of times in this inquiry today, and people's concerns about whether the regime itself provides certainty or removes certainty. This is a conversation I found somewhat hard to follow on the grounds that the market itself doesn't give a lot of certainty in telecommunications, and I think the declared services regime is certainly no more uncertain than the market itself.

The matter was specifically discussed in relation to Telstra and digitising its

own HFC network, but there appear to be two confusing aspects of that. The first is that Telstra seems to be more prepared to engage in continuing to supply a service in an already declared market, namely analog pay TV, than to invest in a market that may or may not be declared and, secondly, doesn't appear to beyond the ken of man to think of various methodologies that could be utilised by Telstra to make a version of its digitisation available in such a way that there was an access available that would remove the threat of regulation.

The thought that goes through our heads is at the very least Telstra could contemplate the idea of a digitisation of their network, a reservation of a component of that network for access seekers and, to resolve the whole question of pricing, auction that access to a number of access seekers. It doesn't seem to be a particularly complex methodology. It does perhaps run counter to what I think is Telstra's real concern: they just don't want any access seekers on that network at all.

Finally, on the question of certainty, there seems to be a great deal of concern that aspects of the regime may be intrusive, and therefore what we should all rely upon is the ordinary provisions of Part IV of the Trade Practices Act. As my friends from Optus suggested, relying on Part IV doesn't exactly give you certainty if four years later after an event you're still in a process of litigation. It also doesn't seem to be a good way of keeping lawyers out of the loop if we're going to suggest the best way around this is to wind up in litigation.

More importantly, there have been a number of references today already to some matters that have been originally before the courts that supposedly give greater certainty as to the operation of section 46, but it is my understanding that those matters are both currently subject to special leave to appeal - Boral is subject to special leave to appeal - so I'm not sure that the certainty matter has been resolved there. I could go on further and describe what we've actually given you in words, but I'm going to take the radical assumption that you've read the words and leave it to questioning at this stage.

PROF WOODS: Thank you. I'm interested in pursuing your vision, as no doubt my colleague is as well, and I've noted it down - of the multiple facility and service providers in a vibrant marketplace, buying and selling. We can pursue that towards the end, but thank you for that. Perhaps at the start of our discussion on XIB, you made reference to the question of generic versus specific regulation and correctly identified that we do see benefit wherever possible of having generic regulation in terms of declaration, criteria, pricing principles and the like, but that where there is a compelling case, that you then depart from those or maybe extend or augment those principles and policies to reflect the particular circumstances of the industry sector concerned.

We are consistent with our views in the way we deal with XIC at the call level, but then identify that there are specific features of the telco industry that warrant augmentation, and we develop those in our declaration criteria. For example, in the

application of our view to XIB we see that section 46 in particular would be an appropriate generic model to apply, but we'd be interested to know if XIB was to be repealed whether you can draw on specific instances of likely behaviour by Telstra that would cause you concern and that you would feel that you don't have an avenue to progress in a timely manner.

MR HAVYATT: I can give you a couple of examples, or at least one specific example from recent experience, where we certainly sought the engagement of the commission. That was the matter of AAPT trying to obtain a roaming agreement with Telstra on their CDMA network. There were some specific conditions under the terms under which Telstra would provide that roaming that had a significant effect upon the investment that AAPT would need to make in that network. Taking regard to the commission's original decision on the roaming on mobile networks, where they concluded that were roaming arrangements not to be commercially negotiated, the commission would have regard to a declaration or taking action under Part XIB.

We did raise the matters with the commission. Now, that matter hasn't progressed to a conclusion and probably will not progress to a conclusion, given our decision not to construct that network. I believe that self same issue, though, is likely to emerge with anyone who's a new entrant building a third generation mobile network, and so that could still be an issue. The second one is the matter that a number of occasions - and we've mentioned earlier today the $3 call; the case of Telstra when they first introduced a capped long-distance call led to investigation by the commission of a matter under Part XIB.

That matter was stood aside because the commission took the view that getting the access prices resolved first was a first order issue. I think those price squeeze issues will re-emerge quite dramatically once various aspects of the access regime are finalised, and I think XIB will remain for some period of time the most appropriate method for the commission to address those kinds of behaviours. The obvious question is, why not section 46? The bottom line: at this stage it would appear that a section 46 matter will happily get resolved and damages to be paid by Telstra but long after the competitor has gone under.

It was that specific aspect of telecommunications and the structure of the market at the point where the regulation was introduced that appeared to be the justification for XIB in this market. Our concern is that XIB is working like the radar signs, to use your speeding analogy. XIB is certainly something Telstra has regard to. XIB is certainly the process whereby, when the speeding behaviour is about to occur, there is a mechanism where that can be curtailed before the damage is in fact done and before competition is in fact damaged.

PROF WOODS: What are the important features of XIB? Is it the effects definition rather than purpose, or is it the competition notice, or is it some other feature? What are your priorities that you'd want to retain out of XIB, if at all?

MR HOWARTH: It's a bit of both, but to answer your question directly it's the mechanisms and the processes which support the effects test, rather than the effects test itself. Looking at the difference between a purpose and an effects test, we think that there are very good arguments that one can run, either in the commission or in the court, that the same sort of conduct is likely to have an effect and a purpose and, indeed, section 46(7) as you've referred to allows inferences to that effect.

PROF WOODS: That's been part of our concern in this debate.

MR HOWARTH: Yes.

PROF WOODS: We think 46 gets you in practical intent to a sort of purpose test through the inference.

MR HOWARTH: Yes. As I say, it's not our primary concern. The one thing that we would say, though, is that our experience is that the presence of the effects test has influenced Telstra's conduct, and I think there was some further indication of that this morning when the Telstra representative said, "Our behaviour is to obey the law." That suggests that they will obey the law, or they will conduct themselves in a competitive manner up and to the point that they consider the law requires them to. Having the effects test there has been useful on occasion to make the point that, regardless of Telstra's purpose, the results of their conduct have been anticompetitive and that has resulted in a diminution in consumer welfare, in our view.

As I said, the main argument that we make is that the administrative regime, which is there supporting the effects test, is vitally important to the continued development of competition in this industry. We find it unusual and quite confusing that parties such as Telstra would make an argument that having that process there leads to uncertainty because, as David has outlined, under the section 46 approach you would invariably find yourself in litigation if you were serious. The procedure under XIC, after the 1999 amendments, allows the commission first to investigate and, where it has a reason to believe that there is anticompetitive conduct, to investigate expeditiously - there's a statutory duty to investigate expeditiously - and then to issue either a Part A or a Part B competition notice which outlines with great certainty what the commission's concerns are and gives Telstra the opportunity to respond, either by seeking an exemption from that notice or by convincing the commission that the notice should be revoked or varied, or by challenging that notice effectively and continuing with its conduct.

To date, as has been noted in a number of submissions, Telstra has not sought an exemption from notices. Telstra has not generally challenged the notices on administration or, when it existed, on merits grounds and Telstra has not fully defended any action where a competition notice has been issued. Telstra has always modified its conduct.

PROF WOODS: Is that surprising or unsurprising, given the penalties if you ultimately take it through the court? I'm just wondering what you can draw from that when the meter's ticking at a million dollars a day.

MR HOWARTH: I think, to be honest, the penalty regime is a slightly separate issue, and we can address that issue of deterrence separately. But Telstra in other areas has never shown a reluctance to engage in litigation where it believes that it is right, and we would question whether Telstra would easily withdraw itself from XIB action if it did truly believe its conduct to be innocent.

PROF SNAPE: Where we come to the penalty, nowhere else does it face a million dollars a day.

MR HOWARTH: That's correct. Just on that I'd again make the point that Telstra doesn't face that penalty until a competition notice has been issued, and that's the difference between Part XIB and section 46 as well, that Telstra may be subject to penalties under 46 - admittedly smaller penalties but penalties nevertheless - without the commission analysing its conduct first. If you follow the process through - and we would encourage the commission to use its powers more aggressively and, in particular, use advisory notices more often - there are mechanisms in place which are designed specifically to avoid the sorts of errors which some submitters have suggested would occur under these regimes. So for those reasons we think that the effects test is justified and, more particularly, the process which supports that effects test is designed and does in fact take account of the possibility of errors.

We have approached the commission on a number of occasions - and David has outlined one of those - where we've thought that Telstra has engaged in anticompetitive conduct and, as the Optus representatives remarked earlier on, the decisions haven't always gone our way. We've often walked away from the commission unsatisfied, and the reason for that is that there is a very carefully constructed filtering process which we must go through - to reach Mr Suckling's analogy - in order to reach the top of Mount Everest and have a competition notice issued.

PROF SNAPE: Would you advocate that an effects test then be incorporated into 46? The logic of what you were saying seemed to be that you would suggest that that should - - -

MR HAVYATT: The logic perhaps does suggest that. Our difficulty is that to advocate that we're talking about a whole range of other places and we don't know how to describe necessarily the right circumstances for that to occur. The reason why we think it's particularly relevant to this industry as opposed to any other industry is the somewhat unique technical characteristics where you do have the network effects that can create fairly rapid consequences of anticompetitive behaviour and the economic factors related to investment profiles and the historical fact of the incumbency of Telstra. There's an element to which we recognise that the

reason behind having this test in telecommunications has some contextual basis. I don't know how to describe that contextual basis to make it a generic provision. That's the only reason we didn't pursue a recommendation of making it a generic provision.

PROF WOODS: On various occasions through your submission and in your presentations you have strongly advocated a very specific regulatory environment for telecommunications, and you talk about speed and technical change and the like, and your retention of XIB is consistent with that approach. I asked the previous participants whether they would comment on the views of their "to be" owners - or majority shareholders to use the correct phrase. Are the views that you're expressing those expressed by your owners in terms of generic versus specific legislation?

MR HAVYATT: These are the views that relate to the market in Australia, and that's the only thing we're here to talk about, which is the views that relate to the market in Australia.

PROF WOODS: So what is the differentiating feature of the Australian market that warrants these views?

MR HAVYATT: There are two elements to that. The specific factor of this market as opposed to some other markets is, as I've specified, the current position of Telstra in this market, and the second position as far as we're concerned is in fact the regulatory history in this market. One of our greatest concerns about XIB, for example, is the signal that it sends to the incumbent if you repeal XIB, so it's the issue of, well, if you didn't have XIB, maybe there wouldn't be as strong an argument to say introduce one today, but the risk and danger of repealing XIB, given the signal that it sends to Telstra that somehow or other there is some constraint on their behaviour which has now been lifted, causes us significant and real concern. As I said, the position in other markets is different to that; they've got different legislative and legal histories.

PROF WOODS: The one I'm thinking of certainly does, but they are moving in a different direction - yes, in fact moving closer to our direction.

PROF SNAPE: Although the actual Commerce Act in New Zealand is very similar to it - - -

MR HAVYATT: Very similar, and getting more similar.

PROF SNAPE: - - - so it's not as if one is starting from a different point in view of the generic competition policy.

MR HAVYATT: Yes, but there's just so many telecommunications differences in terms of the complete absence of a telecommunications regulator in the last X years in a whole range of features that I think just makes it extremely hard to - it's a bit like

the pricing principles; it's very hard to make an analysis based upon one specific element rather than the totality.

PROF WOODS: You make the point - and I'll certainly give it consideration - that moving from an XIB to an absence of XIB in itself signals a change that Telstra may interpret in a way that you consider undesirable. Is that the same issue that then surrounds your approach to our draft recommendation 8.1? You've got a sentence in your submission that says - where we're talking about changing the objects clause:

> Merely aligning the objects clause with that in Part IIIA is not a sufficient benefit to outweigh the costs of narrowing the focus to a theoretical notion of economic efficiency -

and then you say -

> and the uncertainty which will result from changing the statutory criteria -

so are you seeing that process of change in itself as being particularly important, as distinct from the end point of the change?

MR HOWARTH: Yes, we do. That argument is slightly different to the XIB one. With XIB the question is, is the test purpose or effects, which is a fairly simple - - -

PROF WOODS: Yes, but - no, the point of the change in itself creating a signal I think is similar to what we're discussing here.

MR HOWARTH: Yes, that's right. That change from effects to purpose would create a signal, but we think, as we've said, fairly muted. The change that's being proposed in regard to XIC is a far more dramatic one, and we think that it sends a number of signals. The reason that that change is important is because the objects clause in Part XIC pervades most of the remaining provisions, and the commission has noted that a change to the objects clause would require a change to section 152CR. But, with respect, there are a number of other sections which would also have to be changed, and in particular the commission's assessment of undertakings relies on a test of reasonableness, which then refers to the long-term interest of end users in section 152AH.

Similarly, the consideration of whether a declaration should be varied or revoked in section 152AT refers to that test. Now, the proposal or the suggestion was made earlier that the commission would recommend grandfathering all of the current declarations, but we still think that that change of itself would create a number of possibilities for participants to game the regime by seeking reconsideration of previous decisions under the new test. One example would be a consideration or a reconsideration of undertakings. It may be that the parties which have already submitted undertakings would form the view that, while it failed under

the old LTIE test, it may get up under the new test.

PROF WOODS: As in put another "do" loop into the system and - - -

MR HOWARTH: Yes, and with the greatest of respect to those parties which have put undertakings up before, they have done it repeatedly.

PROF WOODS: How many parties are you referring to?

MR HOWARTH: There aren't all that many. You can count them on the hands of one finger! The second point is that those parties - and there's a great identity between these parties and the other parties - may seek to have exemptions from those declarations done on the same basis. So by changing that test halfway through, as we see it halfway through the process of ensuring effective access, it creates a number of signals to the participants to have another go, and we think that that would be a likely outcome.

PROF SNAPE: I'm just thinking about ways - a consideration as to whether it might in fact be a better test as such.

MR HOWARTH: Certainly, and on that point we would argue that it's not inherently a better test.

PROF SNAPE: Well, picking that point up, then, would you then argue that Part IIIA should in fact have a long-term interest of end users in it?

MR HOWARTH: It may well do, in appropriate circumstances. As David has already outlined, one of our visions for telecommunications is the idea of a seamless web of equal parties contracting with each other, and an essential element to having effective telecommunications is any-to-any connectivity. It's a factor which, to be fair, is often assumed but has in the past been the basis of some declarations or deeming of some services, and we think that in itself in the context of the telecommunications industry is an important aspect of the long-term interests of end users.

Perhaps there's an argument that competition and investment would both be incorporated into the commission's proposed test of overall economic efficiency and to that extent we don't think that the change to the test would make much of a difference, but finally - and this is the last comment - there is some commentary in the draft report to the effect that the long-term interests of the end user test favours one - I think it's a sector or a subcategory of interests within the economy - at the expense of others, and we would say that end users are really the economy generally. The only exceptions to that obviously are telecommunications carriers and CSPs.

Secondly, that comment in the draft report underestimates the importance of the long-term element in the long-term interests of end users test, and that is

something which the commission has repeatedly referred to in its publications exactly on the point of investment and long-term efficiency, that end users have no interest in obtaining a cheap local call today if there is no local communications network tomorrow. So, in essence, in answer to your question, Prof Snape, we think that in practice the change to the test that's proposed by the commission would not alter the regulatory conduct of the ACCC.

We think that it risks understating a very important objective in telecommunications, which is any to any connectivity, and we think that it risks sending a very strong signal to some market participants to game the system in a new round. The LTIE test has of course been in place for three years and it is now quite well understood in this industry, and we don't think that the uncertainty created by the change would justify any benefits from the change.

PROF SNAPE: Yes, we see the point and we in our discussions of it - and I'm not quite sure off the top of my head how the words came out - of course did consider that the LTIE in fact properly applied may be the same as we are recommending. The question is, in day-to-day application, would it bias things one way or another, and that's why the real purpose of it all is to get to the economic efficiency question, and so what we're about is saying, "So that's the real purpose. Let's state it."

MR HOWARTH: Yes.

PROF SNAPE: And that was the thrust of what we were doing. The presiding commissioner is checking up whether we - - -

PROF WOODS: No, I was just reminded that we were referring to removing any ambiguity that might be arising from specifying the interests of consumers rather than the community at large or sort of overall economic welfare.

PROF SNAPE: And particularly as the other wording is in IIIA.

MR HAVYATT: Well, is it the other wording in IIIA or the recommendation for IIIA? I thought IIIA didn't already have an objects clause. In fact it was one of our recommendations in our submission to IIIA that you should in fact include an objects clause in IIIA.

PROF WOODS: Yes.

MR HAVYATT: So when you read the IIIA report it comes from us.
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PROF WOODS: It's just that we didn't see that IIIA would have an end user focus but an economic welfare or economic efficiency focus, and so then wanted to bring the two together. Your comments on gaming the change, though, are quite useful and warrant further thought. In your current submission to us they're a useful three paragraphs, but I find the evidence - and we will draw on the transcript to build out

your views on that, but if you have any further written material that you want to put before us on that issue, that would be very helpful.

MR HOWARTH: We're happy to do that, although we don't want to give our fellow participants in the industry too many ideas.

PROF WOODS: I'm sure they can read transcripts.

MR HAVYATT: We should point out that this is an outline submission. We do have some more material in a couple of the areas that we do want to put together, but we thought it was better to give you a complete review of everything for the purposes of today.

PROF WOODS: Completeness was its hallmark. Thank you for that. That does help our thinking considerably.

PROF SNAPE: As you are building it up further, as you just suggested, on the generic versus sector specific, you heard what Prof Woods was saying before, but also you would have heard the discussion earlier in the day on that question with Optus - - -

MR HAVYATT: Yes.

PROF SNAPE: - - - which again you might like to take into consideration.

MR HAVYATT: We will.

PROF WOODS: I was interested and will also give further thought to your symmetry of sunset provisions, that not only would it give some certainty for the time frame and an end point at which it would be revoked, but that through symmetry should also not be revoked earlier than that sunset timing. I found that a useful point that warrants being made.

MR HOWARTH: There was just one point of clarification that we wanted to ask on that. Our understanding from the initial submissions and the draft report was that the sunsetting proposal was that at the end of the period, whether three years or whatever, the declaration would be reviewed, whereas the conversation this morning suggested that at the end of the three-year period the declaration would automatically fall away.

PROF WOODS: That was Telstra's position in their submission, that at the end of the three or however many years period, that it would automatically be revoked unless the regulator could demonstrate a reason for its continuing, but you're right - - -

MR HOWARTH: It put the burden on the regulator.

PROF WOODS: Yes. In our draft we weren't being so prescriptive and we're looking for input from participants as to whether you do a review at that point or whether the presumption is that it be revoked, and your perspective - I'd be interested in some elaboration of that.

MR HAVYATT: Our perspective - that there should be a presumption that the commission has got to make its case again for the continued declaration, but that those time periods should align to basically get past one element of the gaming that can currently occur, which is just to throw in an argument for revocation right in the middle of an arbitration, just to make the commission's task somewhat harder. The other element of that was - whilst we've got the opportunity - the timing of that sunset provision I would believe would be an appropriate thing for the commission to address in each matter and maybe the most we would want to talk about is a maximum period.

We clearly have a number of cases already where we're four years past the original declaration of the service and the first arbitration under those matters hasn't been concluded. So it would be very dangerous if we had this concept that said because the declarations are automatically revokable after a certain period of time there was then an incentive to game out the negotiations to, once again, create the same problem of revocation inquiries overrunning arbitrations.

PROF WOODS: A useful piece of evidence. You propose the introduction of mandatory undertakings, perhaps with certain criteria such as the requirement of reasonableness. How in practice do you achieve that? I am sure those who have put up undertakings, that we can count on the fingers of one hand, have considered them to be perfectly reasonable.

MR HOWARTH: Yes, the reasonableness test was not so much their opinion of reasonableness but an objective one. A similar process was gone through by the commission in assessing the first of that party's undertakings where there was a standard already in place which was the TAF model terms and conditions code, and that perhaps could be the reasonableness criteria. To be honest, we haven't gone into that level of detail at this point of how you would set those reasonable criteria but that was one example where Telstra itself had agreed to those terms and conditions, so it was a reasonable presumption that they would be reasonable. An unfortunate sentence, however. We should just make the point that the mandatory undertaking provision was part of a package of suggestions that we had made for further discussion rather than being the final ultimate result. There may be elements of that which could be better achieved through another mechanism.

MR WOODS: Yes, it certainly warrants further thought because I would be concerned to insert into procedures just yet another opportunity for delay in gaming. I'd be a little concerned that this might fall into that category, but in the context of a broader package it may have some merit.

PROF SNAPE: I was going to ask if you had given thought to the - forgive me if I've missed it, I was reading this yesterday. But it's on the prices monitoring as an alternative to declaration which is something that we are exploring across the inquiry into IIIA as well as here, and the one on prices surveillance.

MR HOWARTH: Yes.

PROF SNAPE: What we're concerned about here is that there are risks of declaring where it shouldn't be declared and not declaring where it should be declared. What we are trying to seek here is a halfway house, if you like, for monitoring. Do you have reactions to that?

MR HAVYATT: I will give you a brief view. There are two elements to that. The first is the extent to which price surveillance picks up on the XIB powers of record-keeping and reporting anyway, which we actually regard as being very important aspects of the regime. The commission should be in a position to actually understand the dynamics of this market given the powers that it has got, and to put it very bluntly, it's somewhat disappointing to see the extent to which the commission relies upon third party evidence, by a person who is due to appear tomorrow, for its definitions of the size of the market rather than being able to define the size of the market from its own inquiries.

The second matter is that I see price surveillance as being a useful next stage in a large element of this marketplace. Price surveillance would not be a way to establish the first price for a number of the access issues that are currently before us, but certainly I don't envisage - and I'm sure no-one else in this room envisages - that we're going to have the ACCC sitting there doing arbitrations based upon rerunning TSLRIC models for the next 25 years. There comes a point at which one should get some comfort that an effective regime of access has been introduced, and what we're trying to do is watch for anticompetitive conduct, the reintroduction of a squeeze. To that extent price surveillance would be appropriate.

Beyond that we haven't sort of analysed where that right trigger is for the operation of price surveillance, and to what extent it will be able to replace either the access regime or, in fact, the need for early trigger anticompetitive actions, working on the theory that price surveillance also gives you good evidence for a more robust anticompetitive conduct case.

PROF SNAPE: Yes. As envisaged it could either be not a substitute for but instead of declaration, going to a monitoring system, or else for a service which has already been declared, of in fact backing off it or coming off of saying, "Okay, that was declared. Things seem to be going all right. We'll now monitor for say three years during which it won't be redeclared and we'll reassess it at the end." To stop the gaming it would have to be long enough with an assurance that it wouldn't be declared over that period but with an assessment of declaration at the end. That's the

sort of monitoring system that was being envisaged in this, as either a halfway house of declaration or else a substitute for declaration.

MR HAVYATT: We support its operation in both those ways; most importantly coming off declaration because we have identified the fact that in the call termination market you always have market power of the network doing the terminating. So does this mean we're going to have declared services forever in terminating markets? You're completely right that price surveillance of that termination market will probably be the effective way to wean ourselves off declaration. The extent to which price monitoring or price surveillance can work to avoid declaration I think is consistent with - I think somewhere in our commentary we've already suggested that one of the elements that would be available to participants wishing to make an investment that they wished to have not subject to the access regime, that one of the provisions would be that they would need to make information about the operation of that service available to the ACCC which is a version of price surveillance. So we're supportive of both of those. I just can't figure out the criteria at this stage as to where they would be introduced.

PROF SNAPE: We are seeking responses on this, as would have been clear in each of those inquiries, because it is a bit of a new territory here.

MR HAVYATT: Yes.

PROF SNAPE: As I say, the objective here is to be trying to find somewhere between a fairly dramatic step of declaring or, in some cases, a dramatic effect of not declaring, because there is a very big gap between those two things, with the possibility of mistakes in either case.

MR HAVYATT: We agree and we will give some more thought to that. One of the comments that we've also made is the relationship between the XIB regime and the XIC regime, and the fact that in the commission's comments there has been suggestion that XIB wasn't necessary because XIC could have cut in, and yet our concern was whether in the two matters concerned, XIC would apply under the new criteria. I see the surveillance being linked to the suggestion that if you retained an XIB-style trigger for something where you'd applied to say, "Well, I don't want this service declared. You can monitor me and you'll have the advantage of rapid anticompetitive conduct provisions that proves I am being anticompetitive." But we will submit on that.

MR HUGHES: I think also about the negotiate/arbitrate regime we've got in XIC that needs to be recalled in that context is the flexibility that the various provisions provide for improving on the process of negotiation and encouraging negotiation to occur. Particularly since the 99 amendments the ACCC has available to it a wide range of powers; some of them quite serious, some of them look quite innocuous on their face. But there is a whole range of things that can be done. The mere existence of them encourages certain things to occur in terms of the process of negotiation, and

I think that is an important factor of possible difference between the monitoring model versus something which really is aimed at a negotiate/arbitrate with a back-up mechanism.

PROF WOODS: Thank you. A small point: you comment on our recommendation regarding the Telecommunications Access Forum. You say that its role in recommending services for declaration is arguably redundant, therefore lends support to its abolition, but add the rider that there is still a role for industry representative bodies to provide useful guidance on interoperability issues. Are we talking the ACIF role, or are we talking about extending it, or are you talking about retaining the TAF but giving it different functions? I'm not quite sure where you're leading to.

MR HAVYATT: I'm leading to a provision that would look like Part VI of the Telecommunications Act which doesn't actually specify ACIF. It actually specifies that, "A representative body from the industry may", and the extent to which a code in relation to interoperability may be useful and may be something that the commission would have regard to in the remainder of the declaration activities, like the TAF code. That should be an option available for a representative body of the industry, if they meet the hurdles, to register.

PROF WOODS: So it would allow it to be created for a particular issue but without actually legislatively creating the entity and having images.

MR HAVYATT: Yes, exactly. One would expect that ACIF would pick that up but it doesn't have to be ACIF. If it was SMS interoperability, it could be AMPTA, it could be a range of business.

PROF WOODS: I understand your point. I think that might be a useful model. Talking on pricing principles, you considered that the principles the commission proposes represent a theoretically correct set of objectives but proffer some doubt as to whether they should be entrenched in legislations. This is on page 9 of your submission. Your first point is that economic ideas which influence pricing principles are subject to change but perhaps slowly, and not recently. (b) that the ACCC has conducted extensive work on appropriate principles through several public inquiries. To that extent it has built up some case experience, and that should not be dismissed lightly. We agree. You then make the third point though, which is the one that I'd like you to comment further. You say, "It would be unlikely that the principles could be sufficiently precise to lead to the benefits that we claim. In particular, they're unlikely to assist parties in negotiations." Are there any particular of our principles that would be unlikely to assist? In which case, can they be subject to some redrafting, or is it the concept that you're concerned with? What is it that would create greater certainty?

MR HUGHES: I think it's more the concept than the drafting of particular provisions around concepts. I think as parts of the draft report show, some of the

significant differences that arise are at much lower levels of generality than with the basic principles that would be served by the approaches. Witness PSTN originating and terminating access, and the analysis in appendix D of the draft report I think very neatly shows how a lot of the debate can actually be at the level of the methodology and the values as opposed to the sorts of principles that we find expressed in the recommendations.

I suppose at a very, very general level we would like to think that a number of those principles, as expressed in the recommendations, would find their way into regulatory thinking. So it's not the concept so much that we pause on, it is the benefit to be achieved by having them in legislation in terms of feeding through to that negotiate and arbitrate process. Whether it would really assist the parties trying to negotiate. In our experience the differences between the parties tend to be at lower levels of generality. They're about methodology, they're about values, they're about, at times, simply getting hold of information. Hence my point before about the importance of some of the under-process mechanisms in XIC.

PROF WOODS: Yes, we do actually have some views on the importance of process and getting the process right, as well as getting the principles right. We agree with you to some extent, but nonetheless I'm inclined to consider that by all parties knowing the principles within which they will debate the nuances of detail may lead to some greater clarity and certainty by having even those principles subject to challenge from time to time.

MR HUGHES: I suppose one thing we would just comment on in response to that, is that just weighing against it is the cost of flexibility in terms of recognising potential differences in this industry, or potential differences between services. One of the things I think that we find when we deal with regulators looking at access prices is that there are a number of competing points and principles or matters to be taken into account, and judgments need to be made that may differ over time and may differ between various services, depending upon how well the market in that particular segment is developed. The potential cost to going into the legislation of pricing principles is a cost to that degree of flexibility for recognising that in this industry. So we just would commend that that is something to be taken into account and weighed in that balancing.

PROF WOODS: A trade-off between flexibility and certainty?

MR HUGHES: Yes, and to some extent good outcome.

MR HAVYATT: Can I just add on that. The commission's analysis of the problems in relation to access pricing principles correctly identifies the difficulty of dealing with a number of access issues in separate places at separate times. However, the alternative to that is to actually try to regulate everything all at once. I think we're actually trying to have a regime that isn't a regulated regime, but is only using regulation as a backstop, and that certainly principle 1 of your

recommendations would have the very real danger of requiring virtually a complete pricing manual for all the regulated services to be generated at once, which I'm not sure is exactly where we want to take access regulation in this industry.

PROF SNAPE: I think what we're trying to get here is to say that the pricing shouldn't be so low as to have inefficiency and it shouldn't be so high as to have inefficiency. It is implicitly there saying there may be a band between those two, in which in fact the pricing is not having efficiency consequences, but only distributional consequences. Now, we can't be too precise, and we shouldn't try to be too precise as you say later on as such, but they're the basic ideas and we're just setting bands on it. We then go on to say, in fact, something which you take issue with on page 14, that there is greater risk probably of setting it too low insofar as the investment won't occur, than setting it too high in which the investment will occur but it may not be used as efficiently as it might be.

You in fact argued the other way around, which surprised me somewhat, but I see your point, or at least I see where you're coming from. But I mean, if one is talking about really significant investments here, and potentially one is, then not to have it would in fact, to me, be a general and much more serious consequence than in fact to be having it, but that, as you're putting it here, there would be overinvestment which doesn't seem to be the worst outcome. Overinvestment would not seem to be the worst outcome. Not having it at all would seem to be the worst outcome.

MR HAVYATT: Except in two factors. First of all the pricing effects are, to a degree, transitory in the sense that most of the negotiations and indeed arbitrations have not been significant long-term issues. Secondly, the jury is still out to a large extent about the economic efficiency of the duplication of HFC networks in Australia, and I suppose there is still a range of issues to follow that. But I don't really see anyone yet who has walked around the streets and said this was actually a great outcome. Yet it's source was an artificially high access price by Telstra that was the motivation for Optus.

They did not build an HFC network for the principal reason of getting into pay TV. They built an HFC network for the principal reason of providing telephony and pay TV was a way of subsidising the activity. It was the high access prices that they, at that stage, were being forced to endure by Telstra. Many people make a lot of comment about the amount of infrastructure investments taking place today in CBDs. I don't actually see anyone who is saying that fibre loops in the CBDs is an economically efficient outcome.

PROF SNAPE: No, but the comparison might be in - well, there are loops already in the CBD, but with the pay TV roll-out the options might have been none at all.

MR HAVYATT: The options might have been?

PROF SNAPE: None at all versus the duplication. The duplication may not be the

best outcome, but it may be better than none at all.

MR HAVYATT: Yes.

PROF SNAPE: And that's the comparison.

PROF WOODS: The same as the inner-city trunks.

MR HAVYATT: Yes, but that brings back my point about the fact that the pricing is transitory. If the price is set too low, and investment is not occurring, it is not impossible for the price to increase in subsequent rounds so the investment recurs. If the price is set too high, so inefficient investment takes place, that investment can never be recovered in any other way. Most importantly for the incumbent network operator, one would think it's actually the worst outcome possible, because as the person who made that investment ultimately fails that investment doesn't go away. That investment now just gets back into the marketplace at a lower cost. So you ultimately have, for the incumbent network operator, a competing inefficient investment that just won't go away, but each new owner gets to buy it at a cheaper price.

PROF SNAPE: That may be the way that it occurs in some circumstances. In other circumstances like Beta television, Beta videos, for domestic use, it essentially just goes away.

MR HAVYATT: Yes, for the consumer it goes away.

PROF SNAPE: Yes, that's what I'm saying.

MR HAVYATT: Yes.

PROF SNAPE: So it doesn't necessarily get recycled through the marketplace at a lower price.

MR HAVYATT: I think in this issue, most of these networks aren't going to just go away. That's our bottom line reason why we think that if there is an error, the error for high access prices has got the more deleterious outcome.

PROF WOODS: You have some recent experience with writing off partial roll-outs.

MR HAVYATT: Yes.

PROF WOODS: To what extent were they market based, regulatory-driven, technologically inefficient? What were the driving forces for that decision?

MR HAVYATT: On the one you're specifically thinking of I'm not really at liberty

to comment. We have got a number of other investments in access technologies where - yes, we've made investment decisions based upon substitution for one level of access costs, and as the access cost declines you make a reassessment of that investment, and the investment you've made there is no alternative use but to potentially put back in the marketplace at a lower costs.

PROF WOODS: So you just write down some of your balance sheet?

MR HAVYATT: I suppose the difficulty is for me - we've got a big enough balance sheet that I suppose we're absorbing them, but if you actually look around the industry structure at the moment there's an awful lot of assets being turned out into the marketplace at prices that don't necessarily reflect what they cost to build.

MR HOWARTH: There was just one point that I wanted to note. That is that there is a slightly different perspective on investment that AAPT has. I suppose we are, as we've said a number of times, right on the cusp of the build-buy decision, and we've argued previously that access based competition often leads to infrastructure based competition. Putting that into terms of the current discussion, we see that investment is important not only in substitute infrastructure, which is essentially the cable local loops, but investment in complementary infrastructure is also very significant, and we would say in most cases more efficient than further investment in substitute products.

The example for AAPT is very much investing in services in the bush, in regional areas. In a lot of cases we will not seek to duplicate local loop investments, but we will invest in complementary infrastructure, long-haul switching and so on. Without the existence of reasonable access prices that complementary investment will not be possible. Now, we don't argue for a minute that parties should not be compensated for their investments. We have always agreed with TSLRIC and we think that that incorporates a reasonable return on those sorts of investments, but we do say that pricing access too high not only leads to a short-term competition problem, but in very many cases leads to a long-term investment problem as well.

MR HAVYATT: In that we won't invest in the complementary infrastructure.

MR HOWARTH: Exactly. In that we won't invest in the complementary infrastructure.

PROF SNAPE: The shorthand here was fairly short.

MR HOWARTH: Yes.

PROF WOODS: I suspect in practice we're probably not that far apart. There just seems to be the wording giving a slightly different emphasis and direction.

PROF SNAPE: Yes, we have got the transcript for elaboration now. It would be

helpful if you could spin that out a little bit more.

MR HAVYATT: It will be further elaborated on.

PROF SNAPE: Thank you.

PROF WOODS: No, that's quite useful. You've very helpfully commented on a number of areas where we sought feedback. I actually don't intend to pursue questions on those at the moment, but I do thank you for the time that you've taken to give us that information.

PROF SNAPE: What was the outbreak of measles?

MR HAVYATT: I can't give you the actual year, but the case was that when there were still manual switchboards, when you rang up the switchboard you actually said, "I just want to speak to John Smith," or Mary or whatever.

PROF SNAPE: Right.

MR HAVYATT: It was a case of an outbreak of measles in a town somewhere in America that led to the town doctor being concerned that the switch operators would get sick and wouldn't know which plug went with which person. So they introduced numbering and you actually started asking for the number you wanted, so that the switch operator didn't need to be as highly trained. That's where telephone numbers came from.

PROF WOODS: Thank you.

MR HAVYATT: The same as it's useful to know the profession of the person who invented the automatic telephone exchange. He was an undertaker.

PROF WOODS: I don't have any more particular questions.

PROF SNAPE: No, I don't either, so I guess that brings us to the vision thing. You've heard the earlier - - -

PROF WOODS: You've given us a vision.

MR HAVYATT: Given a bit of a vision.

PROF WOODS: Could you elaborate? I mean, it did sketch out a perspective that I've taken note of.

MR HAVYATT: That's a very non-convergent vision thing that I've given you thus far, which is - - -

PROF SNAPE: We are looking to the convergent type of - you know, the future.

MR HAVYATT: Yes. At the very start-off of that operation in the kind of vision I'm looking at it's the people who own infrastructure who are actually looking, at all times, to how to maximise the return on that infrastructure. There is a feeling that the vertically-integrated model of a telco doesn't result in people always looking at how to maximise return on that infrastructure by other people using it. The intention is to maximise my return at the retail level by being the only person who has got control of that infrastructure.

That's incredibly important in all the convergent services and the example we've discussed, which is the pay TV, or digitalisation of the pay TV networks. The models that we're currently seeing don't seem to have a great platform in terms of people with a huge investment actively seeking other participants in the industry as their partners in growing the use of that infrastructure. The pay TV case is a really good one to analyse.

When Telstra was first of all considering its analog pay TV network - and, yes, you're right, it was planning to build one very slowly before another party encouraged them to build it faster and gave them a road map as to where to build it - Telstra was looking at a 20-channel service and offering that in the marketplace, and they had four people all lined up to offer content and they were all going to offer what I refer to the space junk, which was all the channels of programming that come across from America. So each of them would have been running CNN - four operators each using up cable capacity to show CNN. There is a clear argument about some kind of closer relationship between the service provider and the network operator, but it doesn't necessarily need to be as tight as that outcome.

I was conscious of the conversation that we were having earlier about the content industry and the pricing of content. The content industry operates a bit like the VHS-Beta argument. The content wants to be on the platform that's got the most number of subscribers and the decision about who they will offer content to and at what price is linked to that self-same conversation. We can sit there and wonder about why people threw so much money at a second-rate sport - sorry, Rugby League fans - but why did people throw that much money at a supposed piece of content because it's about aggregation of customers to generate what some people would argue is a network effect. The more people who watch that channel, that platform, the more people will want to provide content to that platform - "Because that's actually the way I maximise my return, I'll actually offer it to you at a cheaper price if you can deliver me more subscribers."

So there are network effects in operation wherever we look and that's where AAPT suddenly hits the wall and says, "Well, hang on, are we actually suggesting that these kinds of effects that we're seeing in telecommunications occur everywhere, and that in fact access regulation needs to address these." Access regulation as we currently see it is in fact a very old economy access regulation structured around

boring things like energy and railways and, yes, there's a bit that touches on telecommunications. But all the stuff that's about standards and intellectual property and content aren't really being addressed at all.

That conversation - I'm not sure - comes from a telecommunications access regime conversation. Perhaps it should come from a IIIA conversation, which is why we took the effort to submit on IIIA and, as I said, it's disappointing that more people didn't submit on IIIA to some of the new economy issues and tended to focus on IIIA as entirely in relation to infrastructure. Whether the vision will happen that participants in the industry will see the light and recognise that there is a need for a greater participation of people as seekers and providers or not, I at this stage can't foretell. The only thing I can suggest is that the continual operation of a regime that we've got, at least that's part of it.

MR HOWARTH: Now that we've had the vision, we can get back to the nuts and bolts. The summary, I suppose, if I can be so bold as to put it in these terms, is that we have, as David pointed out, a regime in place which AAPT broadly believes is functioning well. Certainly it has encouraged a degree of competition since it was introduced in 1997, and in that context we argue that the commission must assess the claims of those that seek change to the regime against a fairly stringent cost-benefit analysis; that the supposed benefits of any changes have to be proved to outweigh the costs. It's similar to the process which the Office of Regulation Review, I suppose, would go through with a regulatory impact statement, but there has to be a clear case for change. In our view, and summarising it in one word, we just don't think that there is at this point a case for the significant changes which are outlined in the draft report.

PROF WOODS: I liked your vision. Are there any other matters that you wish to put before the commission at this point?

MR HAVYATT: I think not. I think we have listed ourselves to appear on the IIIA matter, where we might try to address some of those issues, if we can get our heads around more generic questions than our specific dungheap.

PROF WOODS: Thank you for the time and effort that you've put into the submission and into today's presentation. It has given us areas of very useful thought. Are there any others present who wish to make a brief submission to the commission this evening? That being the case, we reconvene at 9 o'clock tomorrow morning. Thank you.

AT 5.36 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 15 MAY 2001

INDEX

	Page
TELSTRA: BRUCE AKHURST DEENA SHIFF PAUL PATERSON	2-45
OPTUS CABLE AND WIRELESS: PAUL FLETCHER ADAM SUCKING DEREK FRANCIS	46-83
AAPT LTD: DAVID HAVYATT PAUL HUGHES, FREEHILLS DAVID HOWARTH, FREEHILLS	84-105