

## **CEDA Luncheon**

**6 April 2005**

**Title: Stimulating a competitive telecommunications sector as Telstra is privatised**

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Optus has been the champion of competition since we entered the market in 1992.

So if there is one thing we think we know a bit about, it is what works - and what doesn't work - when it comes to setting the rules for open competition in telecommunications.

We have watched with great interest the raging debate about the sale of Telstra - and what it means not just for our industry, but for our nation's economic future.

Today I would like to add Optus' voice to the debate.

I want, in essence, to make three main points.

Firstly, regulation should be about creating open competition - rather than about backing Telstra as the means to achieve national outcomes.

Secondly, the Government is exploring operational separation of Telstra. Optus believes this could be a positive for our industry – depending critically on what operational separation actually means in practice.

But to be frank we do not think it is the most important thing the Government could do right now.

So my third point is that the most important thing the Government can do is stimulate the competitive rollout of broadband networks - seizing a once in a generation opportunity to bring true competition to Australia's local loop.

Before I turn to these issues in a bit more detail, let me make an observation about what is at stake as decisions are made about how Telstra is privatised.

This is, frankly, one of the most critical issues of microeconomic reform which our country has ever faced.

As Gary Banks, Chairman of the Productivity Commission, observed in an address to CEDA late last year, there is a pressing need for further competition related reform. He noted particularly that 'further pro-competitive reform in the communications sector remains very important' and he said that

prior to any further sale of Telstra, 'there should be an examination of the appropriateness of the company's structural configuration.'<sup>1</sup>

There will be many seductive voices whispering in the Government's ear right now, urging it to go a bit soft on competition just until they get the sale away.

I think the technical term for these seductive voices is a 'scoping study.'

But if this job is not done properly, the impact on our economy's efficiency and competitiveness will put thousands of jobs at risk.

The stakes are that high.

Let me turn first to one of the recent whisperings from those seductive voices.

### **Telstra's request for an access holiday**

Telstra has recently proposed that it should be given a legislative holiday from the access rules so that it could build a national 'fibre to the home' network.

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<sup>1</sup> Address by Gary Banks, Chairman, Productivity Commission, to CEDA, Sydney, 29 November 2004

At Optus, we are one hundred percent opposed to this suggestion.

We think regulation should be about creating open competition - rather than backing Telstra as the means to achieve national outcomes.

Yet Telstra is trying to position itself as some kind of national champion – and wriggle out of its clear legal obligations.

The law says that if you own a so-called bottleneck facility - such as the telecommunications network owned by Telstra - then you must provide 'access' to that network so that your competitors can use it.

According to Ziggy, in a recent press interview, Telstra's suggestion is all about leading Australia into the sunlit uplands of ubiquitous high speed broadband access.<sup>2</sup>

"This is the big national issue for us and for the nation, and that is a critical bit of infrastructure. We can describe a world where everybody needs high bandwidth, whether it's for commerce or for social reasons."

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and Melbourne, 6 December 2004: NCP and beyond: an agenda for national reform, pg 9  
<sup>2</sup> Article by Michael Sainsbury, The Australian, 14 February: Telstra eyes fibre partners.

Well, excuse me. Telstra might describe such a world, but based on their track record if we leave it to Telstra we're going to be waiting a very long time before they deliver such a world.

Australia's household penetration of broadband services today is one of the poorest in the OECD. We are at 20%, compared to Canada at 42%, Hong Kong at 64%, and the world leader, South Korea, at 76%.<sup>3</sup>

And a big reason that this has happened is because Telstra deliberately kept broadband prices high - with the aim of keeping its customers on narrowband internet for as long as possible.

Narrowband has been a very nice earner for Telstra, particularly since many users take a second line for it – which they tend to drop when they go to broadband.

The fact is, Telstra has effectively enjoyed a regulatory holiday on broadband since its inception. Even today, it is under no regulatory obligation to resell DSL to any other telco.

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<sup>3</sup> Based on Macquarie estimates at March 2005; estimates for US and Canada from Merrill Lynch.

The resulting level of broadband penetration hardly persuades us that such holidays are an effective policy tool.

In fact, broadband penetration only took off when Optus entered the DSL market in early 2004. Telstra responded with sharp price cuts. The result: total broadband services jumped to 1.5 million in December 2004 – more than doubling in twelve months.<sup>4</sup>

If Optus had not acted decisively in early 2004, I would suggest to you that broadband penetration would still be stalled.

The lesson is clear: the best way to foster the rapid take up of broadband is to drive as much competition as possible.

Not only is Telstra's suggestion bad policy - it is also completely unnecessary.

Telstra says it needs this access holiday to give it certainty on its return on investment for a fibre rollout.

But there is already a law which would give Telstra the certainty it needs. Under this law, Telstra and the ACCC can agree on access pricing before Telstra builds the network.

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<sup>4</sup> ACCC media release: 1.5 million broadband services connected: ACCC on 2 April 2005

Which suggests that the real reason for Telstra's proposal is much more straightforward – it wants to get a good old fashioned monopoly on the next generation fixed network to the home.

### **Operational separation**

So having dealt with Telstra's suggestion, is there another suggestion for regulatory change which deserves more serious consideration?

There is: the recent announcement by the Minister for Communications, Senator Helen Coonan, that the Government would be looking at the 'operational separation' of Telstra.<sup>5</sup>

A day after the Minister set out her proposals, Graeme Samuel voiced the ACCC's support. He said that measures that would force Telstra to "operate as if it were running two or more separate discrete businesses" would "offer a far superior means of both detecting and fixing anti-competitive behaviour".<sup>6</sup>

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<sup>5</sup> Address by Senator the Hon Helen Coonan, Minister for Communications, Information Technology and the Arts to the Australian telecommunications Users Group Conference, Sydney, 9 March 2005, pg 7.

<sup>6</sup> Address by Graeme Samuel, Chairman ACCC to the Australian Telecommunications Users Group on 10 March 2005

Let me be very clear in stating that Optus welcomes this commitment of policy energy by the Minister and by the ACCC. Optus is eager to participate in this work and to give our perspective – a perspective built on our company’s track record in delivering real benefits to Australian consumers wherever we have been allowed to compete.

Certainly, our view is that the problems which operational separation is designed to address are very real. As the vertically integrated owner of monopoly infrastructure, Telstra can and does impede competition by providing inferior wholesale services to its competitors.

Let me cite three different ways in which this happens.

First, Telstra can simply refuse to sell monopoly services to competitors. Right now, Telstra is simply refusing to sell Optus a service known as Business Grade DSL, in most parts of Australia.

Secondly, Telstra can offer higher performance processes to its retail business than to competitors. For example, Telstra routinely offers its large corporate customers better service levels on connecting and repairing voice and data networks than it offers Optus as a wholesale service.

Thirdly, Telstra can give its retail business lower access prices than it gives to its competitors. This was precisely what we saw last year with Telstra's DSL price squeeze.

Telstra dropped its retail DSL prices so sharply that they came very close to the prices at which it offered the equivalent wholesale service to Optus and other resellers – meaning that the wholesale price it gave itself must have been a lot lower than the wholesale price it gave us.

So the question on the table is, will operational separation solve these problems?

There is a lot of detail to be worked out before we will know the answer. Even in the UK, operational separation at this stage is merely a proposal from the incumbent British Telecom to the regulator.<sup>7</sup>

Let's remember, we've been here before. In the 90's accounting separation was the flavour of choice for regulators.

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<sup>7</sup> Ofcom's Strategic review of telecommunications: Phase 2 consultation document, 3 February 2005.

<sup>9</sup> Address by Ed Willett, ACCC Commissioner to SPAN on 1 April 2005: Promoting effective competition within the telecommunications sector, pg 1

It took several years of hard effort to implement - but the objective was lost in the detail and what we now have is voluminous reports that no-one reads because they have little practical value.

Don't just take my word for it – listen to what ACCC Commissioner Ed Willett said in a speech just last Friday:

‘We have repeatedly made clear our view that the current accounting separation regime has not been successful.’<sup>9</sup>

So, does this mean operational separation is doomed to similar failure?

Not necessarily – but it does mean that there are some critical requirements which must be met if it is to work.

We think there will be four signposts of success – price fair; treat fair; track and report; and revisit regularly.

By ‘price fair’, we mean that Telstra’s access division must be set up as a separate operational entity. Telstra Retail will have to buy the same services as Optus and Telstra’s other retail competitors. There will need to be clear and visible transfer

prices, and Telstra Retail and the new Telstra Access division will need to prepare accounts based on these transfer prices.

By ‘treat fair,’ we mean there must be a clear prohibition on price and non-price discrimination by Telstra Access - that is, it may not treat Telstra Retail differently to its other customers such as Optus.

If it does treat Telstra Retail differently, there must be rapid enforcement action - without having to prove that the breach has resulted in a substantial lessening of competition.

By ‘track and report,’ we mean there must be monitoring and reporting requirements on measures of discrimination. For example, there should be regular public reports of the service levels that Telstra Access gives to Telstra Retail – and to Telstra Retail’s competitors.

And by ‘review regularly,’ we mean there must be a regular review process built in. After every three years, the operation of the whole system must be publicly and formally reviewed – to see if it is working, and to see if changes need to be made.

### **Bridge to broadband**

I think you will see that we feel operational separation could be a worthwhile addition to the regulatory framework.

But is it the most urgent priority for Government action right now?

In our view, no.

Let us remind ourselves of the outcome we are seeking from regulatory action: a sustainably competitive market structure – which in turn will deliver lower prices, more innovation and better service.

We have that structure in the Mobile market. Just look at the fierce price competition which is presently going on, with the widespread adoption of capped call offers.

But we do not yet have that structure in the fixed sector.

Indeed, as ACCC Commissioner Ed Willett said in a speech late last year, Telstra's ownership of the local loop,

‘results in it being largely unconstrained by the existence of competitors, particularly in relation to residential

consumers where Telstra clearly dominates the customer access networks.’<sup>10</sup>

That could change – if the Government acts decisively to capitalise on the coming of broadband.

It can secure a competitive market structure - and break open Telstra's current dominance of the local loop.

At Optus, we think the lessons of history - in this case, the history of mobile competition - are compelling.

When the new technology of GSM mobile commenced in Australia in 1992, the Government handed out three licenses – one to the incumbent Telstra, and two others, to the new entrants Optus and Vodafone.

The Government took two other far sighted decisions at that time.

Firstly, it mandated attractive resale margins. This let Optus resell services on Telstra’s analogue AMPS network, generating significant revenue and cashflow, and building up a substantial customer base.

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<sup>10</sup> Address by to Ed Willett to AFR 2<sup>nd</sup> Annual Telecom Summit, Sydney, 15 November 2004: ‘Gaining a competitive edge in the telecom sector’.

In turn, as Optus built out its GSM network, we were able to transfer our resale customers across to that network.

Secondly, the Government required Optus and Vodafone to sign Network Development Deeds, under which both carriers committed to roll out their networks to specified proportions of the population by specified dates.

The policy has been tremendously successful. Today there is massive penetration of mobile services, with over 85% of Australians now having a mobile handset.<sup>11</sup> In turn this has created substantial employment and economic activity.

Equally importantly, the market structure is robustly and sustainably competitive. There are four separate operators each with its own network. Telstra has around 45% of the market; Optus has around 35%; and Vodafone and Hutchison are strong and vibrant competitors<sup>12</sup>.

By any measure, this has been a triumph of outcomes based regulation.

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<sup>11</sup> Industry Metrics based on Telstra's reported results – Telstra December 04 numbers (H1) due 10 Feb 2005 (supplied by Optus IR)

<sup>12</sup> Industry Metrics based on Telstra's reported results – Telstra December 04 numbers (H1) due 10 Feb 2005 (supplied by Optus IR)

And the reason it worked was that a wave came along – the new technology of GSM mobile – and the regulators climbed aboard that wave with some clever and strategic thinking.

Well, broadband is the second great wave which is breaking over the communications sector. It offers an extraordinary opportunity for creative and aggressive regulators.

Why do we believe this? Because, like Mobile, broadband delivers a compelling new way to lift productivity and improve personal lives.

Because, like Mobile, broadband will also carry voice as well as data.

And because, like Mobile, over the next five years the take up of broadband will jump sharply – with an estimated one in two Australian homes and small businesses likely to make a broadband purchase decision for the first time.

As Shakespeare wrote over 400 years ago:

“There is a tide in the affairs of men, which taken at the flood, leads on to fortune. Omitted, all the voyage of their life is bound in shallows and in miseries.”

Decisive action by Government to stimulate competitive entry will lead on to policy fortune – a vigorously competitive broadband market.

If the opportunity is missed, we will have a broadband market dominated by Telstra – and I must say I think that ‘bound in shallows and in miseries’ is a pretty good description of that prospect.

That is why, at Optus, we think that operational separation is important – but catching the broadband wave is even more important.

It can create the competitive environment that operational separation can then maintain and optimise – whereas operational separation cannot create a competitive environment on its own.

Just as in the early nineties the Government mandated attractive resale margins on analogue AMPS, today the Government should mandate attractive margins on resale of local call services on the fixed network.

For three years the local call resale price should be set at ten cents; and the wholesale line rental should be capped at twenty-five dollars per month.

In return for this, the Government should extract a commitment from the recipients of those margins to roll out competitive broadband networks using unconditioned local loop copper.

Optus has described this policy initiative as a ‘bridge to broadband.’

Today I am giving a commitment from Optus. If the Government introduces concessional resale pricing as we have proposed, Optus stands ready to sign up to a legally enforceable deed with the Government, committing to rolling out our own broadband equipment in several hundred Telstra exchanges across the country by December 2006.

### **Conclusion**

We are at a turning point in the Australian telecommunications industry. It seems clear that Telstra is to be fully privatised.

The way it is done is absolutely critical – not just for the telco industry, but for Australia’s national competitiveness.

I have discussed three different ideas which have been put forward.

I think we've disposed adequately of Telstra's request for a regulatory holiday.

I have given you Optus' views on operational separation – and the four signposts of success.

But most importantly, I have argued that the real priority in telecommunications regulation is catching the broadband wave – and riding it all the way in to a competitive market structure, just like we did with mobile – which can then be maintained and optimised by operational separation.

Let's get this one right – not just for our industry, but for our nation.

Thank you.