

○ FIGHTING THE MONOPOLY BOGEYMAN

THE MYTHICAL BASIS FOR STRUCTURAL SEPARATION

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Structural separation is a tool available to regulators when it is apparent access regulation and competition policy are failing. In Australia there is prolific competition, but because of ACCC pricing policies, that competition is clustered in high-value suburban areas, and is still reliant on access to Telstra's local loops. Competitors have failed to move up the 'ladder of investment' because lower rungs have been under-priced. That is history. We now need massive investment in next generation networks. Out with the ladder, and in with a high-cost escalator! An FTTN investor not only takes on a much higher risk, without sufficient demand signals, confidence in a commercial return, and a stable regulatory environment, there won't be an FTTN investment. Structural separation not only increases the commercial risk, it decreases the chances of the investment ever taking place by separating the demand and supply sides of a company



FROM BOGEYMAN TO NIGHTMARE

The bogeyman was created to scare children into behaving. When facts and rational argument fail, we turn to fear: 'If you go outside without me, the bogeyman will get you!'

The Telstra monopoly is an elaborately-constructed bogeyman that has no basis in fact, and disappears when you turn on the light.

However, like all bogeymen, the monopoly myth exists to serve a purpose. It is nurtured by those who should (or do) know better, in order to scare up interest in further and more drastic regulatory intervention – *like structural separation*.

RESALE COMPETITION

The argument often goes that as Telstra owns the ubiquitous copper access network, it must be a monopoly. However, Telstra doesn't have exclusive use of that network. It is required by law to give access to its network to carriers and carriage service providers. There are more than 160 licensed carriers and around 500 Internet Service Providers.

In addition to resale competition based on access to Telstra's end-to-end voice and data services, competitors can offer their own services by accessing unbundled local loop services. The copper line from the end-user customer is disconnected from the Telstra network at the exchange and connected to the competitive carriers' networks.

As at June last year more than 5.2 million customer lines were in exchange areas served by Telstra's competitors using their own equipment capable of being connected to these unbundled loops. In other words, around half of the addressable national market could be reached by competitive carriers using unbundled local loops. (Telstra July 2007, 5).

INFRASTRUCTURE-BASED COMPETITION

In addition, those who cry 'monopoly!' forget that there is also competition from completely different technologies, or platforms, not reliant on Telstra for end-user access. In the service area mentioned above, there are 3 million customers who can also be reached by one of four companies

providing alternate cable or fibre networks, and 3.5 million people with access to fixed wireless networks for voice, local calls and data (Telstra July 2007, 5).

THE HFC MALAISE

One problem is that current regulatory pricing is diverting investment from these completely separate competitive networks toward those investments that still cling to Telstra's network, utilising that last mile of copper. The ACCC has been setting prices for that last mile at ever lower levels. While Telstra has submitted an undertaking to charge \$30 per month for unconditioned local loop in the populous suburban areas, the ACCC has reduced prices to \$14.30. (The price set by the ACCC for line sharing services is just \$2.50 per line per month.)

As a result of low ULL prices, SingTel Optus is leaving its HFC cable asset undeveloped while easy money is to be made from cheap, below-cost access to Telstra's copper loops.

Singtel Optus December Quarter 2007 results provide a telling story. For almost 12 months Optus has been running a strategy to drive customers from its off-net services (resale of Telstra lines) and onto ULL-based services or their HFC. Because of ACCC price incentives, clearly ULL is the favoured path. The year-on-year growth in voice telephony over HFC was 5.3 per cent, and over ULL, 330 per cent (Singtel Group February 2008) Broadband over HFC has grown 21 per cent per cent year on year, but over the same period the growth in broadband over ULL has been 484 per cent (including wholesale of ULL services).

More than half of all SingTel Optus' broadband connections are now over ULL. If you fear infrastructure dominance on the part of an incumbent, surely the way to encourage true infrastructure investment is to make it the economically rational choice for a competitor.

It is ridiculous to try and prop up a failing policy regime with even more destructive regulatory intervention like structural separation. The problem here is that access to Telstra's network is too cheap and too easy. Structural separation is sometimes touted as a remedy in situations where access to an incumbent's network is too expensive and too difficult – not the case in Australia.

For no apparent need or benefit, the significant risk of structural separation is reduced investment – but more of that later...

OPERATIONAL SEPARATION

Those who call for deeper and more value-destroying separation of Telstra conveniently ignore the separation regimes that have been in place – first Accounting Separation, since superseded by more rigorous Operational Separation.

There are now firm, enforceable and audited rules and processes in place to ensure the confidentiality of wholesale customer data, the separation of wholesale and retail business units, and the equivalence of service and price provided to both.

Extensive reports are published on line, quarterly, which state data on a range of measures governing the quality of service provided to wholesale and retail customers. On a range of service metrics, a tolerance of just two per cent is allowed before explanatory action is triggered. There are occasions, for various operational reasons, when wholesale customer service outperforms retail! (Telstra December 2007, 6)

It is the nature of business to be suspicious of network providers when they are also retail competitors, but none of Telstra's competitors which provide wholesale services are subject to the same rules and transparent reporting as Telstra!

Why do you need structural separation when Operational Separation already provides volumes of information and transparency around pricing and equivalence of service? There is no systemic discrimination between wholesale and retail that would necessitate structural separation.

THE FTTN INVESTMENT RISK

If the monopoly bogeyman has a spooky sister, she is called 'vertical integration'. Vertical integration is also painted as some kind of monster to be feared. However, vertical integration provides one of the best chances that a large scale investment like fibre-to-the-node will occur.

If you structurally separate a company into retail, wholesale and network operations, you lose the nexus between consumer demand and supply-side investment. The network operator no longer knows who will want to buy its services, or in what volumes, so the risk of the investment increases significantly. It may deter the investment indefinitely. It is a problem to which the poster child for functional separation – BT's Openreach – has already admitted.

In an interview with The Guardian newspaper, Openreach's Chief Executive, Steve Robinson, outlined the difficulties associated with upgrading the residential broadband network under the Openreach model:

The economics simply do not work unless BT Retail and rivals such as Sky, Tiscali and TalkTalk agree to make use of the new technology and pay for it. In essence, 'the decision about whether to put fibre in is not just a BT decision', he (Robinson) says. 'Our model says we do not take the whole value chain, we do make it available to everybody else and that means the financial case is even more demanding.' (Wray 2007)

Telstra is willing to make the FTTN investment, and provide open access to its competitors, because it at least has the assurance of the demand forecasts of its retail arm, and the anticipated sales of its wholesale operations.

Even though in this FTTN scenario you have one network provider, competition is preserved because of the different nature of the service.

The traditional wholesale of telephone services for voice and data relies on access to a line over which a ready-made service, of a standard quality, is offered for resale to end-user customers.

There is very little opportunity for the reseller to add value to the actual product, except in the quality of their marketing, customer relations and billing.

In the FTTN world the access seeker gets what is called a 'bitstream' service. This is the raw product out of which the access seeker can offer its own differentiated products. It does this by developing its own services and applications – voice, content, email, video, IPTV, HDTV etc – which transform the raw material into a product.

It is like the difference between a company having access to pre-packaged bottled water to re-label and resell to its customers, and the original stream of water. If you have the raw product, you can decide to make it into ice cubes, or bottle it yourself with added flavour and bubbles. These products are much more valuable than water.

The provider of the original stream of water makes money from the *volume* of water it sells – and it must sell as much water as possible to any access seeker, including its own retail operations, in order to cover the high costs of developing the pipeline.

It is the same thing for an FTTN network. If the owner of the network is able to sell at wholesale and retail it has a better chance of recovering its large building costs. It is competing against other access seekers in the market place at the retail level, but the competition is real competition based on differentiated services and products. In other words, you don't need tight regulation of a margin for reselling exactly the same service. All you need is equivalent price and non-price access for all retail and wholesale users of the raw material, and the market will then ensure competition based on each player developing better services, better value or being more efficient.

THE CASE FOR STRUCTURAL SEPARATION

Those who call for structural separation therefore need to be very clear on the problem they are seeking to remedy. It appears that a number of critics base their demands for structural separation on the mere fact that Telstra is vertically integrated. But SingTel Optus is vertically integrated, as too are most of the major telecommunications carriers around the world. Indeed it is likely that any bidder to build FTTN will be vertically integrated in some fashion.

There is no problem with vertical integration per se, as it provides benefits in terms of efficient end-to-end service delivery, reduced intermediation costs and improved investment planning – because of the links between the customer/demand and building/supply sides of an organisation.

The downsides of vertical integration are ameliorated in the Australian context by the extent of competition, as outlined above, and by the existence of measures such as extensive reporting requirements, which provide assurances of equivalent treatment for access seekers.

Those who bang the structural separation drums are beating the best chances of providing their children with a better internet future.

It is important to look at their motivations

While the G9 carriers put forward a proposal for a fibre to the node network, it was a delaying tactic. Their clear financial interests remain with cheap ULL access to Telstra's networks. If this weren't so, why hasn't SingTel Optus invested more in its existing HFC cable in competition to Telstra's cable?

Ironically G9, in its bogus FTTN proposal, was boldly seeking a monopoly – with one of its conditions of supply being a law to stop anyone building a network in competition. G9 wanted a statutory monopoly, not Telstra.

Telstra has offered open access to its FTTN at non-discriminatory prices. The only thing is, Telstra wants to ensure that the pricing allows it to make a commercial return on the investment.

Those who are making arbitrage profits from ULL access have made FTTN the new bogeyman, under the label 're-monopolisation'.

Those who are scared of this new bogeyman are not only behaving like children, they are buying into the plan to hold Australian broadband back.

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