development, partial deregulation is likely to be the worst of all worlds.

I believe that governments should review the outcomes of the NEM and determine its broader objectives and structure, rather than involve themselves in the ongoing development and operation of the market.

### The nation's future energy market: a first-best approach

We now need to develop clear, future directions.

Investment responsive to users' needs is vital for developing an interconnected market and systems security in both gas and electricity.

In electricity, greater demand-side responsiveness is urgently needed. That is, extreme inelasticity of demand simultaneously makes wholesale prices particularly volatile and enables generators to wield strong market power, especially when supply and demand is tight.

Price signals need to drive decisions about network augmentation, generation and load location, and interconnection, to have investment decisions made in an integrated, consistent manner. How should that integration be provided? By price signals, not by central planning.

I understand that such developments are seen as threatening by some. Turning energy security and reliability as well as pricing over to the market is perceived by some policy makers as a loss of control, which would still be accompanied by a responsibility for fixing things when they go catastrophically wrong.

Of course, such a scenario concerns energy ministers and treasurers. And to be fair, no-one should expect them to look on such a prospect with equanimity. A greater concern arises because of what has been created now—an electricity market that is only half done.

If the market is working well, then treasurers, ministers and citizens will sleep at night knowing that, as with bread and milk on the shelves of corner shops, there will be electricity in the morning.

What is needed therefore is a comprehensive plan for how we get to a fully developed, well-working market.

Governments will ultimately need to commit themselves to that objective, but they can only be expected to do so once they are convinced it really is achievable—once they are happy with the plan. The plan therefore needs a lot more work.

### Conclusion

The coming years are critical and important ones. The operation and governance of the national energy market will continue to be an area of strong interest. So far the process of reform has delivered considerable benefits to users, industry and the economy. But for benefits to continue so must the reforms.

Perhaps the independent review for COAG can be the mechanism detailing how a fully integrated national energy market can work, and outline what is needed to make it work. For instance a starting point could be the role of networks in the NEM and the transition path to a full functioning market which included adequate demand side involvement and full retail competition.

## Launch of *Australian Telecommunications Regulation*

*Following is an edited version of a presentation given by Commission Chairman, Professor Allan Fels, at the launch of the Telecommunications Law Centre's second edition of* Australian Telecommunications Regulation *on 6 December 2001.*

This is a timely launch for a book on telecommunications—especially given the continuing strong public interest in the state of competition in this dynamic industry.

In recent times, the sector has changed and grown rapidly. It grew 6.4 per cent (for 2000–01) following on from 12.3 per cent in the year ending March 2001. However, it has slowed notably in recent months with a decrease, the first in 10 years, of 2.7 per cent in the June quarter. The worldwide downturn in the communications sector has led to extensive job shedding and rationalisation on both the international and domestic fronts presenting real challenges for companies and for regulators around the world.

### Australian Telecommunications Regulation

As outlined in *Australian Telecommunications Regulation* the competition aspects of the telecommunications regulatory framework are now firmly embedded within the Trade Practices Act.

I want to emphasise the importance of a publication of this type. The overview and detail it provides helps to prevent debate being captured by special interests.

In particular it:

- is a credit to the editors, Alasdair Grant and Jock Given, who have worked mightily and to David Howarth and David Stuart, former excellent officers of the Commission
- is thorough—everyone would acknowledge telecommunications regulation is complex and highly technical; the history of the telecommunications industry in the policy context demonstrates clearly how far we have come
- effectively compares and contrasts the 1991/1997 Acts
- is clear that the key stakeholders have been extensively consulted
- goes to the heart of some of the complex definitional areas such as:
  - whether ISPs are both content and carriage service providers
  - whether content service providers should be subject only to the general provisions of the Act
- is an objective and important reference for policy makers, analysts and industry participants.

## Structural issues in telecommunications

I want to canvass a few broader issues.

The marriage between generic competition provisions and the telecommunications competition specific provisions was in 1997, and there is near universal acceptance of this arrangement. For example, it is supported by the Productivity Commission's draft report into the telecommunications competition specific regulation [final report is available at <http://www.pc.gov.au/inquiry/telecommunications/finalreport/index.html#publish>].

The telecommunications legislative framework is largely service-based—it effectively sets out a process by which we decide what to regulate and then how to regulate.

This means that regulation currently occurs without any reference to the structure of the industry to begin with. Perhaps we need to consider how we regulate the telecommunications industry from the perspective of industry structure, rather than access alone and how our regulatory reference point could be the market power of the incumbent.

For the vast majority of industries covered by the Trade Practices Act, efficiency levels were developed in a largely private sector environment. This is certainly not so for Telstra, which began its life as a publicly owned provider. It was corporatised in 1991 and has been subject to competition, albeit of a limited form, from new entrants since 1997.

## Different models of regulation

In April 2001 the OECD released a paper on structural separation in regulated industries. It found that, in telecommunications, activities that are usually non-competitive include both:

- the provision of a ubiquitous network
- local residential telephony in rural areas.

In addition, it identified activities that are potentially competitive including:

- long-distance services
- mobile services
- value-added services
- local loop services to high volume business customers, especially in high density areas
- local loop services in areas served by broadband (e.g. cable TV) networks.[1]

While this description largely fits the Australian telecommunications industry, Australia's position is unusual in that the owner of the local loop is also a 50 per cent shareholder in the major pay television cable network.

The combination of vertical integration of carriage services with the ownership of strategic content provides Telstra with unparalleled market power in the domestic market. Clearly, this has significant implications for competition in both price and services.

## OECD models for protecting and promoting competition

*Access regulation*

This is intervention by the regulator to fix the terms and conditions under which rival firms in the competitive component acquire access to the non-competitive services (Part XIC of the Trade Practices Act).

[1] Organisation for Economic Co-operation and Development (OECD), *Structural Separation in Regulated Industries* (Directorate for Financial, Fiscal and Enterprise Affairs Committee on Competition Law and Policy, 2001, p. 4).

*Ownership separation*

Non-competitive and the competitive activity can be separated vertically, protected by line-of-business restraints or integration controlled in other ways.

*Club ownership*

Joint ownership of the non-competitive activity by firms in the competitive component.

*Operational separation*

Non-competitive components are placed under the control of an independent entity.

*Separation into reciprocal or smaller parts*

Separating non-competitive components into smaller reciprocal ones counters the demand-side economies of scale (i.e. consumers are prepared to pay more to be connected to a network through which they can contact more people).

*Accounting, functional and corporate separation*

Separating different accounts, functional divisions and corporate entities although owned by the same company will, as described by the OECD, limit:

> ... the need for regulation that is difficult, costly and only partially effective ... it reduces the incentive of the provider of the non-competitive activity to restrict competition in the competitive activity.[2]

Australia has to some extent adopted this approach by introducing a regulatory accounting framework.

The OECD also outlined the quality of regulatory processes under a regime in which structural separation has **not** occurred:

> An integrated firm, in contrast to a separated firm, benefits from any action which delays the provision of, raises the price or lowers the quality of access. An integrated firm will therefore use whatever regulatory, legal, political or economic mechanism in its power to delay, restrict the quality or raise the price of access. Furthermore, the integrated firm has strong incentives to innovate in this area, constantly developing new techniques for delaying access. Although the regulator can address these techniques as they arise, it is likely to always be 'catching up' with the incumbent firm. Regulation, despite its best efforts, is unlikely to be able to completely offset the advantage of the incumbent.[3]

This may sound familiar. The Chairman of Telstra, Mr Bob Mansfield, recently told Telstra's shareholders at its AGM:

> The right to appeal is the basic principle that holds the present system together, creating incentives to commercially negotiate. Other carriers were no doubt encouraged to negotiate by the Government's proper lack of support to abolish or water down appeal rights. Without appeals there would be little incentive for those seeking access to negotiate.[4]

This could be interpreted in two ways.

The first is how Telstra has interpreted merit review as 'the basic principle' for creating incentives to negotiate. And the second is that the retention of a merit review process has led to commercial access rates being higher than those which the Commission sees as efficient. Also the threat of a lengthy tribunal process effectively gives Telstra the ability to leverage the price of access rights against the access seeker's strong need for certainty.

Telstra's deliberate strategy of using regulatory delay as a tactic was recently referred to by Telstra's group managing director, Wholesale, Media, Legal and Regulatory, Mr Bruce Akhurst:

> We have moved from just under 40 disputes to just under 10 ... I am not interested in taking a confrontational or legalistic approach. We have done that for years [emphasis added]. Now is a real opportunity to take a commercial approach ... We are really trying to grow the retail market by providing great solutions to the wholesale market ... My focus will be on the commercial resolution of outcomes and customer service.[5]

I am certain Telstra's incumbency and strong degree of vertical integration gives it an unparalleled advantage in the Australian market. At Telstra's most recent annual general meeting (noted above), it outlined its performance as superior to its international and domestic peers. The Commission recently engaged Ovum to conduct a study which concluded that Telstra compared favourably with SingTel and Telecom NZ. SingTel's performance overall appears the strongest of the three—in

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[2] ibid, p. 16.

[3] ibid, p. 17.

[4] Bob Mansfield, Telstra annual general meeting, 16 November 2001 at <http://ww.telstra.com.au/newsroom/speech.cfm?Speech=17341>, accessed 19 November 2001.

[5] *Exchange*, vol. 13, no. 45, 3rd Wave Communication Pty Ltd, 23 November 2001, p. 3.

Ovum's view, this reflected the level of SingTel's dominance in its home market, which has only recently been deregulated.

Ovum's analysis also found that Telstra's return has been diminished by its (non-regulated) domestic and overseas investments, with write-downs of more than a billion dollars recorded.

Additionally, a recent Macquarie Research Equities publication found that:

> Overall, Telstra was most frequently the most expensive provider with its offerings for residential telephony service, broadband and dial-up Internet usage and ISDN service all being ranked behind both Telecom NZ and SingTel in the respective home markets.[6]

It is clear from the work of the OECD that the competitive environment is significantly influenced by the extent to which the incumbent is fully integrated. The circumstances of the Australian telecommunications market are such that the fully integrated incumbent wields substantial market power.

Any regulatory environment therefore needs to take full account of such market power and recognise that regulating it appropriately in the national interest needs a full set of regulatory tools.

The OECD has described the success of access regulation—that is, what we currently have at our disposal in Australia—as being dependent upon the regulator's resources, information and instruments of control.

Given the fully integrated nature of the incumbent, in the absence of structural change, it becomes even more important for the existing access-based regulatory regime to be made more effective by:

- introducing a compulsory undertakings power
- developing conduct standards
- changing the current flawed process of negotiation, arbitration, and re-arbitration.

[6] Macquarie Research Equities, *Call Forward*, vol. 77 (2001, p. 5).