

Introduction

The Federal Government has released a discussion paper requesting comments on how to create “a more effective framework that serves the interests of consumers and businesses” in the telecommunications sector.¹ Instead of pre-determined views, the Government has an open mind on what reforms should be made.

On this basis, the following views are offered on the big policy questions facing the nation and telecommunications, including the fundamental issue of whether or not regulation can, in the end, effectively advance the public interest.

Free Market Implications

The free market delivers efficient outcomes to the benefit of the whole community. While this is a basic tenet of our policy framework, it cannot be known in advance what this actually entails. What consumers want and how much they are willing to pay for it cannot be pre-empted or defined. Like the stockmarket, the price is only known after the event. The inscrutable process of flowing resources into those areas most valued can thus only be represented by the metaphors of seminal thinkers like Adam Smith (self-interests provide for a benevolent “invisible hand”) and Friedrich Hayek (the economy, if left to its own devices, will achieve a “spontaneous order”).

If all this weren't true – and there was a formula for economic success or share prices could be accurately predicted – the market wouldn't be needed in the first place.

The entrepreneurial spirit, having the same attributes, provides a consistent link between this big picture and market participants. A profitable business will use a certain degree of science, but its ultimate success is thoroughly dependent on decisions that draw upon “artistic” expert commercial judgement. Our highest policy goal is thus contingent upon an “X factor” that is unseen, beyond measurement and cannot be mechanised for the benefit of the community.

This has some obvious implications for governments and policy-makers.

Its ethereal features means there is no way to control efficiency or force private enterprise to make the right decisions – how can this be done if there's no way to know beforehand what “right” is. Governments have no silver bullets. It's also a challenge for the public to accept the efficacy of the free market when its essence can't be seen or proved. A further dilemma arises from the fact that the discretion required by the private sector to grow the economy, lift living standards and improve employment prospects is the very same discretion used to perpetrate the market failures that economic policy seeks to overcome. Regulation imposed to address market power abuse, for example, must also compromise the upsides of capitalism.

Ironically, the Hilmer Committee, which advised on the establishment of National Competition Policy (NCP) and the principles of open access, touched on such realisations, noting that market power, being the downside of the same metaphysical coin, cannot be defined.

The central conundrum in addressing the problem of misuse of market power is that the problem is not well defined nor apparently amenable to clear definition. Even if particular types of conduct can be named it does not seem possible to define them, or in circumstances in which they should be treated as objectionable, with any great precision. For example, it may be possible to say “predatory pricing” is undesirable, but it does not seem possible to give a clear definition of what will amount to predatory pricing in all circumstances.²

The Committee even explicitly recognised the inseparableness of anti-competitive behaviour from efficiency-enhancing decisions:

¹ Department of Broadband, Communications and the Digital Economy (2009) *National Broadband Network: Regulatory reform for 21st century broadband*, Discussion Paper, April.

² Independent Committee of Inquiry into Competition Policy in Australia (1993) *National Competition Policy: Report by the Independent Committee of Inquiry into Competition Policy in Australia*, AGPS, Canberra, p. 69.

... the challenge is to provide a system which can distinguish between desirable and undesirable activity while providing an acceptable level of business certainty.

Tellingly, this complication was simply assumed away:

In addressing this challenge, the Committee starts from the position that there is already in place a regime which provides a basis for making the appropriate distinctions.

Low and behold, there is no such regime. The liberty used for good is the very same as that used for malevolence. And offering freedom on the condition it will be used for the right reasons is not freedom to start with. Further, it's illogical to endorse commercial freedom, constrict it and then expect all the upsides originally promised. There are three possible responses to this immutable trade-off:

- Absolute control – All freedom is withheld on the basis that “we cannot simply hope that individual market participants somehow magically do the right thing”.³ The command economy option, operated by a centralised entity singularly focussed on the public interest, is designed to rid the economy of all wrongdoing.
- Absolute freedom – Regulation is abandoned on the assumption that business will do the right thing if given the opportunity.
- Mixed economy – Business is encouraged to put their capital at risk and, in the process, generate economic activity. The discretion required to achieve this implies trust. At the same time, however, business is regulated because it is mistrusted.

The mixed policy approach has many undesirable side-effects. To appreciate what these are, however, one must be willing to tackle the intractable issues arising from the free market philosophy. Does a “middle-ground” approach, for example, lock us out of achieving our ultimate policy goal because regulatory interventions also restrict the commercial freedom required to achieve efficiency? Is trust and mistrust of business an unreasonable mixed message? Likewise, is it possible the behaviours targeted by regulation are the result of confusion and resentment caused by such mixed messages? Is regulation a self-perpetuating monster, feeding its defensiveness when confronted by such possibilities?

Like Hilmer, such issues have been disregarded, glossed over by rhetoric and propaganda designed to convince the public that regulation is a costless enterprise capable of solving any problem.

The tensions that arise from such a closed approach to policy have been particular evident in the highly-regulated telecommunications sector. Some of these issues are discussed further below.

Competition

Competition and efficiency are not one and the same. As noted in the Regulatory Reform paper, the former is a means, generally an effective one, to the public policy goal of delivering “high quality services to consumers at affordable, sustainable prices through the most efficient providers”. The paper (p. 3) also states that the:

... overarching objective of the 1997 telecommunications regulatory reforms was to promote the long-term interests of end-users of telecommunications services, and the efficiency and international competitiveness of the Australian telecommunications industry.

However, because efficiency is impossible to define or measure, competition has come to assume the mantle of the “real” policy objective.

³ Rudd, K. (2009) “The global financial crisis”, *The Monthly*, Issue 42, p. 28.

The ultimate objective of access legislation is to enhance community welfare. In an operational sense, however, this is difficult to convey in a meaningful way. To this end, the objective of Part IIIA [of the *Trade Practices Act 1974*] has been couched in terms of promoting competition in the delivery of infrastructure services.⁴

A natural penchant for the tangible over the vague has meant any policy suggestion that does not promote competition (eg vertical integration) is automatically taken to be detrimental to the public interest. Most stakeholders are convinced competition, and the regulation imposed to promote it, guarantees efficiency. The link is “made real” by the language adopted by government, regulators and those who immediately benefit from legislative-based competition.

Want world-class broadband? Sure – just promote more competition and smarter regulation.

Contrary to the free market philosophy, Australia has persuaded itself there is a formulaic solution to its key economic problems.

Because it’s generally not economically feasible to have competing infrastructure-based supply chains in this country, a vertically-integrated provider with significant market share may be the most efficient policy option. The cost of potential market power abuse could be less than the costs of regulating a dominant player and/or enforcing vertical separation. Such a comparison should also account for the qualitative effects related to various subtle twists of the truth.

Competition in telecommunications is really “managed” competition. The ACCC manipulates and controls Telstra in order to facilitate competitive pressures. This is not real, unfettered competition, which is defined as a level playing field where all participants are subject to the same rules.

If a company comes to dominate a particular market segment through hard work and customer service it can expect to be hobbled. In the case of Telstra and other infrastructure owners, restrictions are applied up-front. This is often justified on the grounds regulation protects the competitive process, not the individual participants who compete. This is only true to a point. Regulatory interventions disadvantage a particular company in the hope that the resulting advantage will ensure competition is sustained. Policy-makers and regulators refuse to acknowledge such partiality.

Where pre-reform governments protected particular firms (eg the two airlines policy), the industry policy pursued under NCP doesn’t discriminate. It encourages any and many organisations to come forward and avail themselves of the commercial opportunities (ie economic rent) arising from a policy-based monopoly that pre-empts market structures, sets access prices and guarantees a certain rate of return.

Just because it’s presented in the media as “competition” doesn’t change the fact that managed competition is a form of cross-subsidisation, no different in principle to the distorting policies triumphantly vanquished by NCP. The key difference with NCP-inspired industry policy is that it has spawned a multitude of rent-seeking competitors, who make it even harder for governments to acknowledge the true costs of regulation by informing the fearful public their continued existence is the only way to avoid getting screwed over by Telstra.

Negotiate-Arbitrate Model

The current negotiate-arbitrate model is ineffective, riddled with conflict and unable to deliver commercial outcomes. This much seems agreed.

It’s then presumed, however, that Telstra’s contribution to this situation is confirmation that a tougher response is warranted. Those within the policy-making fraternity fail to ask if Telstra’s litigious behaviour is instead a product of a self-indulgent regime.

⁴ Productivity Commission (2001) *Review of the National Access Regime*, Report #17, AusInfo, Canberra.

It's ridiculous to even use the term "negotiate" when referring to dealings conducted under the auspices of the *Trade Practices Act 1974*. Market efficiency stems from a free exchange between a buyer and seller. It cannot be forced or imposed by a third party, and good intentions don't somehow miraculously alter this reality.

There's no doubt a win-win negotiation with the likes of Telstra requires the dominant, vertically integrated provider to act in good faith. An efficient outcome is at least possible if Telstra does the right thing. On the other hand, believing Part XIC or Part IIIA can demand effective negotiations is naïve in the extreme. Based on the discussion above, it's a contradiction to attempt to mandate efficiency when it's already been accepted as something that cannot be controlled or measured. Moreover, how can the regime promote the necessary good faith if it's already assumed bad faith? Why would a third party work towards a resolution if it understands a regulator with a favourable bias stands willing and able to counter Telstra's presumed malicious intent?

Once the condemned "negotiations" fail, the existing regulatory process moves the parties on to the equally flawed concept of arbitration.

How can the ACCC possibly expect to arbitrate fairly if it assumes the worst of Telstra and various others? It can claim to facilitate new investment by pointing to projects and expenditures. It can argue all it likes over what constitutes a fair rate of return based on the perceived risks. It can spin various niceties designed to convince itself and others of its independence. But the cold, hard truth is the ACCC has an innate bias against those it regulates. True, it is designed to counter potential market failure, but it remains a bias nonetheless, and its denial inevitably creates intense anger and confusion, none of which is presently recognised as legitimate.

This is a criticism of the regime, not the individuals that must attempt to perform miracles within it. Regulators are compelled to migrate away from assurances of light-handed regulation by a cynical public who expect them to be true to their cynical breeding. Imagine the uproar if the ACCC said: "We've looked at Telstra's proposed access terms and conditions and they seem fair"? It must justify its existence – and this inevitably involves attacking those it has been set up to attack. The conflicts that arise from a regime built upon bad faith are inescapable and cause otherwise reasonable people to conduct the kind of improprieties they claim to be weeding out. This two-wrongs-make-a-right hypocrisy was noted by Roger Corbett when CEO of Woolworths:

The previous chairman [of the ACCC] said: "We should have a far more cooperative attitude. You should tell us what your problems are, and we should work with you on trying to get compliance". But when we did that we found many of the officers really wanted to know the facts only to see if you had committed a breach.⁵

Regulatory Certainty

In an effort to counter claims they add to business risk, regulators constantly dangle the promise of certainty in front of those they regulate. The phrase, however, is an oxymoron.

Regulatory certainty requires the ACCC to either give Telstra complete commercial discretion, which is effectively no regulation, or make its decisions purely formulaic, completely transparent and free of professional judgement. The former isn't considered, while the latter makes no sense. As stated by a former Commissioner of the Colorado Public Utilities Commission, regulation requires the same invaluable, unfathomable expertise required of commercial decision-making.

The greatest challenge for the Commission, however, is finding an analytical foothold from which to evaluate the respective merits of parties' pricing proposals. Because the pricing methodology is forward-looking and based on hypothetical, efficient, future built networks, a whole range of plausible assumptions can produce disparate results. [Regulated] prices

⁵ Senate Hansard (2003) Economics Reference Committee, "The effectiveness of the *Trade Practice Act 1974* in protecting small business", Hearings, Melbourne, 30 October.

inevitably are the product of art, surmise and informed predication about forward-looking costs.⁶

If asked, Telstra, assuming it understood the true nature of efficiency, should say regulatory certainty requires access to its network to be set by it because its artistic estimate of various forward-looking parameters is right, albeit ultimately immeasurable, due to it being in the best position to make such an assessment. The third parties reliant on these terms and conditions of course claim such arrogance to be further evidence in support of denying Telstra any such flexibility. Attempting to short-circuit the impasse, the ACCC forms its own opinion on what is reasonable, at which point Telstra rightly asks the same irrational question posed to it: prove this is right?

Arguing over whose subjective view of the appropriate access terms and conditions is correct, only leads to open-ended conflict. As a response, governments have toughened the laws, demanding all parties conform with pre-determined requirements (eg truncated time frames, no appeals) and increased transparency (eg additional confidential information, regulatory justifications). Rather than solve it, this only adds to the problem. The mechanisation of decision-making creates further inefficiencies because the most vital factor – professional judgement – is progressively driven from the process.

This trend is made more pronounced when the resulting problems lead government to introduce more aggressive and extensive regulation.

Vertical Separation

There is no simple answer to whether or not the infrastructure entity should be integrated with a company who uses its services. What's important is that all costs and benefits are recognised. It should also be asked if vertical separation is being considered as a way of avoiding the dilemmas noted above.

Utilities like telecommunications, energy and transport are characterised by an absolute co-dependency between the vertical parts. A train, while technically separate from the physical track, is useless by itself, and vice versa. Efficient network management requires complex trade-offs in both real time (eg train priority and flow-on impacts of schedule changes) and over the longer-term (eg timing of new technology). Getting this right is an art, just as much as it is a science. As noted by the Bureau of Transport and Regional Economics there are no clear-cut rules to account for the nebulous link between network cost and charging the user a fair price:

Although economics may suggest principles for setting access charges, in practice there can be a range of ways of applying those charges. ... There is a considerable degree of ambiguity over cost causation, which can undermine the determination of appropriate pricing signals.⁷

It's therefore imperative the infrastructure-user relationship be honest and co-operative. Aside from traditional scale and scope issues, vertical integration has commercial value because it minimises mistrust, allowing for decisions that benefit the whole, not just one of the parts. An internal retail business is more likely to accept the subjective aspects of efficient access terms and conditions required by its network business. Of course, the downside of vertical integration is an incentive to disfavour third party competition.

Vertical separation, while increasing transparency and thus improving the science side of the equation, puts efficiency at risk because self-interests can use the innate regulatory bias against natural monopoly managers to drive revenue below cost. Prevailing bad faith means access equivalence is eventually interpreted by the regulator as meaning the same terms and conditions for easily distinguished users (eg business versus residential). Greater mistrust and self-interestedness limits scope for proper price discrimination and thus efficiency.

⁶ Gifford, R. (2003) Regulatory Impressionism: What Regulators Can and Cannot Do, *Review of Network Economics* 2(4), December, p. 474.

⁷ BTRE (2003) Rail Infrastructure Pricing: Principles and Practice, Report # 109, p. 32.

As we know, traditional allocatively efficient pricing for infrastructure is ineffective, as short-run marginal cost is considerably less than average cost. A “margin” must be applied. The discretion this requires is acknowledged in the policy framework (eg Ramsey pricing, two-part tariffs), yet the same framework also discourages the network business from being able to set sustainable prices based on its art and surmise.

It's the same old dilemma. Efficiency requires judgement but judgements made by those best placed to know the answer can be used for the wrong reasons. So, efficiency is sacrificed because it's forbidden to even consider allowing a network manager to recover fixed costs based on its assessment of who should pay and how much. Though obviously denied by the regulator, this must result, on average, in an under-recovery of revenue. Apart from causing the decay of existing infrastructure, this has a chilling effect on major new investment.

As evidenced by recent heated disagreements in the vertically-separated electricity supply industry, separating Telstra's network and/or building a wholesale National Broadband Network (NBN) may provide a temporarily excuse to ignore this conundrum, but it's not going to take it out of play.

The notion that the NBN is going to be an easy antidote for regulatory conflict – especially in a technologically-advanced sector like telecommunications – is utterly misguided.

Conclusion

The free market philosophy to which Australia has subscribed presents a number of challenges, most of which have yet to be explicitly addressed.

Efficiency has an ethereal dimension to it that makes it impossible to second-guess reasonable terms and conditions for accessing natural monopoly infrastructure. It requires the exercising of expert commercial judgement on the part of the manager, but because this discretion can be used for the wrong reasons, regulation ends up actively undermining its stated policy goal. To cope with this, the vague-yet-real efficiency goal has been gradually supplanted by competition as the only policy objective of consequence.

The current policy debate provides no latitude for discussing the limitations of the existing regime and the subtle negative side-effects regulation has on business. There's an unquestioned presumption that more competition and regulation will miraculously deliver the desired solution, even though free market principles tell us there are no silver bullets. The existing NBN proposal may be appropriate. It may be the right move to vertically separate Telstra. The crucial issue is: are decisions taking account of all the risks and costs, and not just the all-consuming fear that Telstra will do the wrong thing by the Australian people?

For effective policy to be developed, the spiralling conflict that characterises the current regime must be confronted by facing up to the simple black-and-white choice before us: either continue to contradict ourselves by trying to control what cannot be controlled, or demonstrate real leadership, admit regulation is ultimately useless and work constructively with business to achieve the win-win outcomes expected by the community.

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