

Getting the policy and processes right.

Slide 1 (Title)

The three preceding sessions have trawled over a number of immediate issues such as investment and the broadband push. In this session the topic is getting the policy and processes right. This requires I think a slightly more expansive view both topically and temporally.

There is an assumption in the title of the session that the policy and processes are not currently right. I will explore that assumption as we progress. But before I talk further about telecommunications I want to briefly analyse a policy area which everyone regards as a great success.

Slide 2 (A policy success)

That area is monetary policy and most specifically inflation targeting. This policy has an interesting history as it arose as a consequence of the economic difficulties experienced globally as a consequence of the great macro cost shift created by the OPEC cartel – and the failure of fiscal stimulation to deal with the resulting “stagflation”.

But the policy wasn't got right first. The initial clarion call to monetary policy was issued by the late Milton Friedman. But despite the outpouring of praise for Friedman by groups such as the IPA, the monetary policy he proposed is not what solved the problem. His theory, which was the way the Fraser/Howard Government tried to manage the economy was based on the quantity theory of money and relied upon the ever more esoteric targeting of various money supply variables.

The successful policy of today was only achieved through the combination of micro-economic reform and independence for the Reserve Bank. In fact, the clarity of the inflation targeting means the bank has to act less often. When the economic indicators suggest inflationary pressure is building money markets factor in a likely increase in interest rates into forward rates that can sometimes obviate the need for rises in official rates.

So in summary the story goes that there was a policy decision made, the first implementation failed and the second implementation succeeded. The two core features of the successful implementation are the existence of a very clear objective and a very independent agency charged with achieving the objective.

Slide 3 (Telco policy)

Now let's talk about telecommunications policy. On the face of it we have some similarities. The first is that ultimately the policy is a piece of reform designed to achieve economy wide outcomes. The bottom line is it is designed to overcome the principle problem of monopoly, that is that a monopolist has an incentive to restrain output to drive up price to earn a monopoly rent. But the concern for economists is not the rent – that is just a by product of the problem – it is the deadweight loss experienced through the constrained output.

The second similarity is that the policy has been pursued by the construction of a set of objectives and a set of independent regulators. But in telecommunications we wind up with an explicit objective of industry self-regulation.

Now I want to explore the specified objective a little further here. The objective as we all should now is expressed as the LTIE test with its three wings of promoting competition, of any-to-any connectivity and of the economically efficient investment in and utilisation of telecommunications infrastructure.

At the time of the 2000 PC review AAPT took a very strong view of the importance of this objective, and indeed we thought it was so useful that we (ably supported by Paul Hughes and David Howarth at Corrs the Freehills) submitted to the concurrent review of the general access regime in Part IIIA that a version of the objective should be adapted for that regime. We were successful and the PC recommended that the economic efficiency objective be added to Part IIIA. The PC then surprised us by suggesting that the test be amended in XIC to match the new test in IIIA.

While we successfully objected to that in reality it wouldn't really matter because the first and third limbs of the LTIE test can be inferred from each other, and the second can be inferred from either. So if you will

excuse me I will for the rest of this talk simplify the discussion to say the objective is to promote competition.

This simple two word objective looks so simple doesn't it? But what does it really mean? Unfortunately it is embedded in law that otherwise doesn't define the term and so the definitions that have been adopted by the High Court take precedence.

The definitions that the Court has chosen to apply are largely derived from overseas jurisdictions, primarily the US. The Court has argued that the global marketplace is suited to global definitions. Further the definitions that the Court has applied have resulted in a very narrow definition of competition, driven mainly from the thinking that the purpose of the Act is to promote competition for the benefit of consumers, but not to promote competitors. This is accompanied by language about competition being "deliberate and ruthless", or "rivalrous market behaviour" or about the consequence of competition being to "harm competitors".

This language is all quite worrying, because it tends to focus on the idea that there is only one kind of "competition" whereas there are many. The same is true as we shall see later of the concept of "market".

I have in other places used the analogy of contrasting golf and tennis. Both are competitive individual sports, at their professional level you can get quite rich playing them. In tennis you confront the player on the other side of the net, as part of your play you need to anticipate and react to their shot, and you try to make your shot in such a way as to complicate their next shot. In golf each player is playing the course, you strive individually to play it as well as you can. Your next shot depends on your last shot not your opponents. Professional players avoid looking at the leader board. You do have to worry about matching a titanium head with a titanium head, but mostly you ignore your competitor.

The competition we want in competition policy is more like golf than like tennis. We want competition focussed on the customer not each other.

Technically we don't want strategic interaction – where I think about your reaction to my move.

Slide 4 (Draft Pick)

What's so bad about strategic interaction? The simplest example is one of a draft pick where each team has ranked players in their order of preference as shown. If the teams pick according to their order of genuine preference then the first two teams get their first two most desired players, while the Acacias get their first and fourth picks.

But if the Acacias think they know the preferences of the first two they will pick Frank in the first round forcing the Grevilleas to pick Darren in the second round, and then the Acacias can still pick Charles in the second round. So we have two teams still getting first and second pick, but the other team getting its first and fifth rather than first and fourth as before (and we frustrate the intent of choosing the order of draft picks).

If all the teams pick "insincerely" the players are likely to be chosen in the order Charles, Edward, Frank, Allan, Brian and Darren giving the first two teams their first and third choices and the Acacias their second and fourth.

It is easy to see the decisions about deploying and not deploying ADSL2+ modems as an example of an activity with this kind of strategic interaction.

In simpler versions of the consequences of strategic interaction one encounters the standard theory of oligopoly. These theories conclude that the price outcome in oligopoly can vary anywhere between the perfectly competitive market and the monopoly outcome. It is a worry though that to get the competitive outcome you can conclude that one firm ends up supplying the whole market.

Slide 5 (Where are we?)

The ultimate question is just how well is the policy setting working? Unfortunately we don't know what real costs are so we can't directly determine whether we have cost reflective prices. The regulators instead look at relative prices to report the outcome. While there have been impressive declines there is a question as to how much of the decline is attributable to technological change and how much to competition.

The various Ministers have kept trying to focus our attention on the growth in the number of licensed carriers. Despite all the prognostications of "industry consolidation" the number of carriers continues to increase every year.

But it is not just the number that counts, it is their relative size. A way of looking at this is the "carrier value added" or the eligible revenue included in carrier returns. The data from 1999-2000 and 2004-2005 show that while there has been a growth in the number of carriers their relative sizes barely change – in fact these charts being log-linear by rank order suggest that outside the top few the providers are all progressively proportionate to each other in size.

Slide 6 (Effective competition)

In a paper for the ACCC's 2004 Regulatory Conference William Shepherd outlined criteria for fully effective competition. His criteria called for about five equal sized firms and no dominant firm and low entry barriers. A measure commonly used is the HHI – which is the sum of the squares of the market shares of competing firms. The US merger guidelines specify that there is market power when the HHI is above 0.18 and the Shepherd criteria amount to requiring an HHI below 0.25. The Australian telco HHI is much closer to the equivalent of a full duopoly – near 0.5.

Slide 7 (Promoting competition)

Let us return then to the question of what promoting competition should mean in the Australian regulatory context. The ultimate authority the Hilmer committee definition was “striving or potential striving of two or more persons or organisations against one another for the same or related objects”.

Now there are a couple of problems. Hilmer wanted to argue that firms potentially striving sufficed to create competition – this was William Baumol’s contestability theory. But contestability only works as a theory if there are not significant up front sunk or capital costs of entry, which is clearly not the case in telecoms. The idea that competition can be sufficient with two firms has taken hold solidly in sectors where there are high economies of scale. The alternative is to admit to high economies of scale and instead pursue regulated monopolies. Mind you Optus has been a great fan of the idea that promoting competition doesn’t mean there needs to be more than just the OptTel duo.

You will here in the currency of current debate alternative view on how to further promote competition. One side is made up of people with various specific suggestions to solve the problem, usually some kind of more direct rule making and often by political agents rather than independent regulators. On the other side are the forces of the free marketeers – these are the people who think that any regulation, even regulation designed to promote competition, interferes with the natural order of letting consumers express their own choices.

I think that both these are misguided. I’d like to propose as a hypothesis that what we first need to do is get clearer about the objective, and that a good simple numerical target would be industry structure expressed as the HHI or the Shepherd criteria.

Slide 8 (Designing markets)

One of the other problems in generic competition policy, up there with confusion about what competition is, is confusion about how markets work. Most worrying is the endless use of the phrase “market failure” as the (often only) justification of regulation.

This comes with an assumption that there is one version of market. Well the kind of market that is assumed by economists “proofs” of the efficiency of markets don’t exist. That market is one made up of buyers and sellers with perfect information and all trades occur simultaneously.

If you observe the real world you see many different kinds of markets, you see open outcry produce markets, you see numerous versions of structured auctions and you see markets as regimented as the stock exchange with limitations on information disclosure, maximum holdings without triggering takeovers, etc. All these markets operate by rules – some created by statute, some by convention - and some by the group of conventions that became the common law.

Given this fact it is surprising how little analysis is conducted of telecommunications markets. For example, is it a good or bad thing that many prices are kept confidential – would that work for the equities markets? Is bundling genuinely of benefit to consumers or is it a form of price discrimination that enhances market power and facilitates the extraction of rents? Similar questions can be asked in both the wholesale and resale markets.

These are questions amenable to empirical analysis. They aren’t theoretical answers because they apply to this market differently to other markets. The question is who should do this and how.

Slide 9 (The meaning of ~~Christmas~~ self-regulation)

The other objective that featured highly in the original design rules was making the greatest use possible of self-regulation. This was represented in both the Code making powers and the very specific tool of the TAF.

Two questions were never really asked – what does self-regulation really mean and who is responsible for creating it.

I believe that the correct answer to the first question is that the purpose of self-regulation was to design the appropriate markets. Unfortunately because of the use of the R word most people thought of it in the metaphor of rule making, and of course rule making needs to be married up with policing and enforcement. Very rapidly it became accepted to talk instead of co-regulation, with ACMA co-regulating in industry codes and the ACCC in wholesale markets.

Once co-regulation became the accepted norm the real agenda of market design was lost.

What is particularly interesting is that the objective to use self-regulation is placed in the regime on the regulators, not on industry. But you wouldn't know that from the language of the regulators or the policy makers. These all knowing agencies like to think of self-regulation as an opportunity provided by lawmakers for industry to avoid further laws. So they use their ability to be law makers as a poorly designed threat, because as with most strategic threats, once made they usually have to be carried through.

The only way to get self-regulation working is to be explicit on placing the success of self-regulation in the KPIs of regulators. And, in the case of the ACCC that doesn't mean vacating the field by hoping for competing networks, it means taking responsibility for helping industry develop effective functioning wholesale markets and structures.

Slide 10 (What is to be done)

At the Comms Day debate in the middle of the year I used a few quotes from Chairman Mao. Today I want to conclude with the title of Lenin's pamphlet of 1902 "What is to be done" in which he outlined the need for an organisation of revolutionaries. Whatever one might think of the outcome, that plan was successful.

The very first thing is to get really clear on the objectives of the regime. Globally the core difficulty is that every incumbent telco thinks its mission is to recreate a monopoly or at the very least to maximise market power. Privatisations that have capitalised rents don't help. Understandings of corporate governance that equate shareholder interest with monopolisation don't help. Vague targets don't help.

Just as inflation targeting worked in monetary policy then HHI targeting could work for telecommunications policy.

The next thing is to acknowledge the missing conversation – the conversation about market design. And having acknowledged it is missing get on and get the regulators engaged on the project of getting industry to design the markets.

And I will end this speech reflecting on an opposite to Lenin, the poster child of American Liberalism John F Kennedy who said "We choose to go to the moon, not because it is easy but because it is hard". The mission to change telecommunications from a monopoly to a competitive market was always going to be hard. If we wanted the easy route just regulating a monopoly would do.

And this is not the challenge for industry – this is the challenge for Government.

Slide 11 (Close)

24. But the object of s.46 is to protect the interests of consumers, the operation of the section being predicated on the assumption that competition is a means to that end. Competition by its very nature is deliberate and ruthless. Competitors jockey for sales, the more effective competitors injuring the less effective by taking sales away. Competitors almost always try to "injure" each other in this way. This competition has never been a tort (see *Keeble v. Hickeringill* (1809) 11 East 574 (103 ER 1127)) and these injuries are the inevitable consequence of the competition s.46 is designed to foster. In fact, the purpose provisions in s.46(1) are cast in such a way as to prohibit conduct designed to threaten that competition - for example, s.46(1)(c) prohibits a firm with a substantial degree of market power from using that power to deter or prevent a rival from competing in a market. The question is simply whether a firm with a substantial degree of market power has used that power for a purpose proscribed in the section, thereby undermining competition, and the addition of a hostile intent inquiry would be superfluous and confusing. (*Queensland Wire*)

(<http://www.austlii.edu.au/au/cases/cth/HCA/1989/6.html>)

260 "Competition is a ruthless process. A firm that reduces cost and expands sales injures rivals - sometimes fatally. The firm that slashes costs the most captures the greatest sales and inflicts the greatest injury. The deeper the injury to rivals, the greater the potential benefit. These injuries to rivals are byproducts of vigorous competition, and the antitrust laws are not balms for rivals' wounds. The antitrust laws are for the benefit of competition, not competitors." (US Seventh District quoted in *Boral*)

(<http://www.austlii.edu.au/au/cases/cth/HCA/2003/5.html>)

293 "The existence of barriers to entry may be conclusive in determining the relevant market and the degree of market power in it. In the context of s 46, the existence of significant barriers to entry into a market carries with it market power on the part of those operating within the market. Market power follows as a natural consequence of barriers to entry ... There is, of course, vigorous debate in economic circles about what constitutes a barrier to entry into a market. There are those who would and those who would not accept that the high cost of entry constitutes a barrier. ... However, it is less important to arrive at a precise meaning than to recognize the assistance given by the identification of conditions, in the nature of barriers to entry, for the purpose of defining the relevant market, measuring the extent of market power and determining whether that power has been exercised." (*Dawson J* from *Qld Wire*)

(<http://www.austlii.edu.au/au/cases/cth/HCA/2003/5.html>)

Competition expresses itself as rivalrous market behaviour. In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers. ¹ (Trade Practices Tribunal in *QCMA* decision)