

Eye on the Future

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THE THIRD WAY

Our industry is no stranger to change. If policy and regulation cannot keep up we shall lag behind other countries and forfeit some of the benefits that change will bring. A litmus test of the ability of regulation to meet the needs of the future is the way it regulates investment in fibre. At this point, the omens are not good.

We have to start by noting that access regulation was introduced only after the public switched telephone network (PSTN) had already been built. When competition was introduced in Australia in 1992, around 96 percent of homes were connected to the PSTN. This was achieved by making access affordable with access (line rental) provided below cost and funding this with cross-subsidies from calls. The same business model has been employed successfully by mobile networks. It is only possible where access and calls are provided jointly in both supply and demand.

Pre-selection and call-over-ride torpedo this business model – as I explain to my clients in developing countries^[1]. Competition exploits cross-subsidies; it feeds off them. And when interconnection is provided at cost by regulation, and retail call prices are way above cost, huge rent transfers from the incumbent to new entrants can occur. For example, when call competition began in Australia the price of a five minute call between Melbourne and Sydney with Telstra was \$1.66; but where Optus handled the call for \$1.54, Telstra received only 27 cents for interconnection and Optus cleared over \$1.20 after all costs.

This essay is not arguing that monopoly is a wonderful thing. It is not. The case against it on economic efficiency grounds is strong: it is technically inefficient (eg it gold plates the network and employs too many staff), it is allocatively inefficient (eg it tolerates cross-subsidies which misallocate resources) and it is dynamically inefficient (eg it is slow to innovate).

When Australia introduced competition it already had the network, and it needed competition to provide a spur to the incumbent to increase efficiency, to unravel cross-subsidies (ie reduce call prices) and to provide choice. But what Australia needs now is more fibre in the customer access network: without reverting to monopoly and without undermining investment in alternative access networks (eg wireless).

The focus of current regulation is on sharing the legacy PSTN cake, but it now has to focus on encouraging carriers to bake new cakes. Several alternatives suited to this new focus on investment exist.

First, so-called access-holidays give investors a chance to recoup their investments over a defined period in which they have a monopoly of the services provided over their new infrastructure. This is what Foxtel and Telstra sought unsuccessfully in relation to the

digitisation of the cable network. It is similar to what happens with patents. But, this approach entails the inefficiencies associated with monopolies noted above. We need a model that encourages use of the network.

Second, we could share the monopoly across a cartel. The classic example is the under-sea cable consortium arrangement. These arrangements work and they are unregulated. This appears to be the approach suggested by the 'gang of seven' Australian service providers led by Optus. But all the variants in this proposal depend upon Telstra's involvement; and that seems unlikely.

The third way is to revise access pricing principles. The current regulated access pricing model (TSLRIC) is inimical to investment. Regulation is supposed to mimic the outcomes that would arise in a competitive market. A criticism of TSLRIC is that since it is based on the hypothetical forward-looking costs of an efficient provider, it sets a benchmark price that is logically impossible to beat. Why build when you can buy it from Telstra at TSLRIC?

However, a more fundamental objection to current access pricing is that it ignores opportunity cost. In competitive, real-world markets opportunity cost is not ignored. For example, if I build a stadium to hold football matches what would I charge the Federal Government for holding the Commonwealth Games there? It would certainly not be just the TSLRIC with an agreed return on capital – which is what the ACCC might decide if the stadium were 'declared'. Commercially, I would also want the opportunity cost of allowing the Games to be held in my stadium; and that would be the profits foregone on the matches that would have been held there. This is not only a competitive commercial outcome (other stadia would do the same) but also an efficient economic outcome (presumably the ticket office will draw bigger crowds with the Games, so this is a better alternative use).

Opportunity cost is a real economic cost and can be estimated by the ACCC as easily as marginal costs. Better yet, it points the way to more light-handed regulation because the regulator can forbear from setting access prices so long as they lie between marginal cost and stand-alone cost ^[1].

The third way is the true economic approach if we are to get true broadband. The concept of opportunity cost appears to be ruled-out by an Explanatory Memorandum to the Trade Practices Act. If so, it stands in the way of infrastructure investment in all industries; not just in fibre.

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[1] See 'Access Pricing – Time to Shift Gear' – at www.deridder.com.au