WRONG NUMBER OR SIMPLY CROSSTALK?

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Review of Henry Ergas, *Wrong Number: Resolving Australia's Telecommunications Impasse.* (Allen & Unwin, Sydney. 2008, 256 pp. Paperback, RRP AUD$29.95. ISBN 9781741756487.)

Anyone familiar with the judicial criticism of Henry Ergas for performing more as an advocate than as an expert[1] will not be surprised by this book. He has become a familiar figure in the development of competition policy in Australia, dating from the days of his return from the OECD and working alongside Alan Fels at Monash University. However, over recent years his advocacy has drifted from the arguments he mounted when representing OTC and its desire to enter the value-added services market to his latter incarnation as an expert regularly retained by Telstra.

The book freely acknowledges Telstra's help and they would not regret their support, as the outcome is a collection of arguments of the horrors of the telecommunications regulatory regime (well, actually only one part, the access regime in Part XIC of the Trade Practices Act). These are arguments that Telstra will appreciate, if only because they have almost all been aired by them at some point in the past.

It is, however a pity that some of that funding could not have provided better editorial resources for the volume. It is jarring to find three grammatical (or typographical if we are generous) errors in the first paragraph of a book. This is not a trend that continues, except for some strange section numbering included in the introduction to Chapter 3, which indicates that in an earlier iteration this was actually Chapter 4 and the incorrect labelling of the horizontal access of Figure 7.4. I could also quibble over the choice of terms selected for inclusion in the index.

As an advocate, Ergas does an excellent job in the book of clearly laying out his arguments in a way that makes his reasoning easy to follow. However, clarity of argument does not make up for false or missing hypotheses (or facts or assumptions) or for invalid syllogisms. The detailed structure of the arguments presented here makes them no more persuasive than they have been on the other occasions they have been offered.

The impasse of the subtitle that the book sets out to resolve is the claimed under-investment in telecommunications infrastructure, a situation that is described in the concluding chapter as 'a new major wave of telecommunications investment is required to complete … restructuring and renewing the CAN. This is the key to making the network capable of providing end-to-end very high-speed service. It will not happen in a timely and efficient manner unless the regulatory regime is overhauled.'

The argument that is laid out in the book uses the dictums of all great sermons: tell them what you are going to tell them, tell them, and then tell them what you told them. It does make the book a tad repetitive at times, and does result in some of the more robust parts of the argument getting lost.

The overall argument proceeds as follows. There has been an underinvestment in telecommunications networks because access seekers get access to the Telstra network at artificially low prices and so don't invest in their own networks, while at the same time Telstra is under-investing because it cannot achieve a satisfactory return. The cause of this state of affairs is argued to be a poorly designed regulatory regime that provides too much scope and discretion to the regulator in determining what services to provide access to, that provides insufficient guidance to the regulator in how to set prices and has insufficient opportunities for appropriate review of decisions.

The specific outcomes are claimed to be an excessive list of services brought within the scope of access regulation, and the prices for the services being set using methodologies that are time inconsistent and biased towards achieving the lowest rather than most appropriate price. All of this has been justified by the regulator on the basis that despite the regulation Telstra remains profitable, which amounts to 'soak the rich' taxation and masks the achievement of short term profits by choosing to under invest.

A review is not the place for a detailed response to all the elements of the argument; the comments here will be limited to an overall assessment of the exposition provided. There are many weaknesses in the arguments, and a sample will be chosen that represent the categories of these weaknesses.

All arguments (in the logical sense) start somewhere; the logician calls these hypotheses but other more practical types call them facts or assumptions. For an argument to produce true conclusions the hypotheses need to be true (and complete) and the reasoning valid. The book fails in its choice of hypotheses and misrepresents others. The reasoning in the book suffers from an inadequate comparison, inadequate consideration of the interests at play and most importantly from inconsistent application of economic theory.

This book chooses 1997 as a point in time to start the analysis, and builds from this a conclusion that telecommunications regulation has failed because Optus failed to build a business relying on its HFC network; in doing so three important activities preceding 1997 are ignored. These are the choice of competition model chosen for Australia (in long distance), the strategies by Telstra to introduce pricing plans known as Flexiplans and Strategic Partnership Agreements (SPAs) and the decision of Telstra to overbuild the Optus HFC network.

The model of competition in long distance commenced in 1991 was modelled on the US experience with long distance competition. The very different regulatory model where interstate calls had always been treated differently from intra-state calls (due to the constitutional arrangements) was ignored. The competitor to Optus (Kaloori) did not bid in the end because of the problem with providing a local service. The model was compounded by the decision (opposed vigorously by Ergas and his client OTC) to merge Telecom with OTC.

More damagingly, both the pricing plan decisions and the decision to overbuild were strategies developed by Telstra to respond to Optus. In fact both resulted in actions by Optus under Trade Practices law. The first was settled with an undisclosed payment to Optus, but which all in Telstra regarded as minor compared to the competitive advantage achieved. The second was settled with a payment that Bill Scales describe as a 'trifling amount'. While both were probably settled with no admission of liability by Telstra, they both reflect that there has been a lot more in play than the 1997 access regime.

Telstra's current campaign of complaint about the under-utilisation of the Optus HFC is merely a case of Telstra complaining about the success of its own strategy. They set out to destroy the Optus HFC business case and succeeded.[2]

This leads to another incorrect statement that the book repeats twice: that Telstra is no more or less horizontally or vertically integrated than its major counterparts overseas. In reality Telstra is very unusual; in most markets the incumbent fixed line provider is excluded from Pay TV.

ADSL was the outcome of goal-directed research by the old integrated AT&T for a competitive response to cable operators entering telecommunications. In many markets incumbent operators face competition from operators who have vertically integrated operations at least on the same continent, Telstra has a continent to itself.

Also in these introductory chapters it is claimed that over $3B of taxpayers money has been appropriated to telecommunications schemes and implying that the Government's $4.7B for the National Broadband Network was additional to that. This is erroneous, as it includes the $2B for the Communications Fund in both amounts. But even this claim is later confused as the book states 'Telstra, having had cost recovery continually compromised, refuses to invest in the roll-out of a new high-speed access network unless that network is massively subsidised' (P.163). This is not Telstra's claim; their claim is that they will not build without regulatory relief.

The final area of discussion on hypotheses is the way that Ergas, following Telstra, tries to represent the ACCC's decisions on the price of ULLS as a declining price despite input costs rising. The reality is that the final price rises over time, but that the ACCC was engaged in a protracted process in arriving at that price. The explanation of why the ACCC was forced to revisit the pricing is addressed later, but the use of the outcome as a statement of fact about the pricing is misleading in the least and deceptive at worst.

It is, however, the structure of the argument that is the issue of greatest interest. The primary argument deployed through the book is to describe the characteristics of a 'good' access regime, and then to compare and contrast the telecommunications regime to that standard. In this argument the Part IIIA access regime, the energy access regime and the Gas Code are quoted. In this process the argument relies heavily on an assumption that these other regimes are, in fact, preferred regimes. However, the primary evidence provided for this claim is the relatively limited use of these regimes, the small number of services declared or access decisions made.

The argument can be summarised as a hypothesis that a good access regime is one that is lightly used; these other regimes are more lightly used than the telecommunications regime; therefore the telecommunications regime is bad. This is a poor, if not invalid, argument. Worse, it at times masks some of the more substantial criticisms, including the inconsistent approach the ACCC took to some declarations; the most notable of these is WLR and LCS. These declarations had their origin in the importance of these services to competition in long distance but became subverted to an ACCC campaign for competition in local service.

The argument also fails to recognise that each of these other regimes is dealing only with elements of the structure of telecommunications. For example the Gas Code corresponds only to the declared transmission service and has no comparison to ULL. Similarly many other economic sectors did solve the access issue structurally, relieving the access regime of a burden. None of these regimes has an issue akin to the issue of the bundling of diverse services requiring differential access as occurs in the local and long distance service case.

The argument in the book relies too much on the idea that the only variable in play is the construction of the regulatory regime and perhaps the motivations of the regulator (if the proposition is accepted that the regulator has an interest in expanding regulatory involvement.) This ignores completely the role of other players, notably Telstra's wholesale customers but also of Telstra itself. The first of these comes through in the treatment (pp33–34) of incentives to invest and the failure to recognise that other players make investments complementary to the acquired access service.

The bigger issue is the extent to which Telstra itself was a player and how the regime in practice is a creature of Telstra's behaviour. The book does not deal at all with Telstra's failure to effectively utilise the Telecommunications Access Forum to develop pricing principles for inclusion in an access code; it does not detail the drawn-out process of the only arbitration that went to merits review and the way Telstra managed that matter for delay.

The book criticises the 2002 amendments, which it claims bowdlerised the undertaking process, but were actually motivated by a desire by the Government for greater use of the process in preference to disputes. It tries to lay the blame for rejection of undertakings at the feet of the regime or the regulator, rather than with the providers. The best example of this was the ULLS undertaking. After the ACCC rejected Telstra's undertaking, Telstra submitted a new undertaking at the ACCC's indicative price. However, Telstra advanced all the same supporting material and attempted to intimidate the ACCC. This resulted in the ACCC taking another detailed look at Telstra's claims and 'opened the door' for arguments about the wider distribution of the so-called ULLS specific costs.

An alternative view of where the access regime has taken us is that Telstra has consistently taken a bet that it will be able to intimidate the regulator, the Government or its customers into submission. This bet has consistently failed (though there have been moments of weakness). Where there are avenues for appeal, Telstra has consistently lost.

Last but not least the book relies at times on various pieces of economic theory. This is a combination of very static analyses of markets including things like the risks of double marginalisation. At other times the book uses more dynamic arguments, even mounting institutional or evolutionary arguments about the role of monopolists in innovation. While these are all individually convincing, they cannot be consistent. This would be a bit akin to trying to apply quantum mechanics and Newtonian mechanics in analysing the one problem.

As a consequence we see claims that 'inefficient outcomes would obviously never prevail were the regulator an omniscient, omni-benevolent social planner, capable of setting the terms and conditions of access with Goldilocks-like precision' (P.35) but in a subsequent discussion of structural separation we are told that the price system cannot possibly manage the co-ordination of upstream and downstream investments. That which is beyond the capabilities of a regulator is supposedly within the talents of the Telstra CEO!

This reasoning ultimately results in Ergas asking us to believe that it is necessary for us to accept the inefficiencies necessary for firms to earn rents as incentives to invest, but does not ever explain why these inefficiencies are better than the inefficiencies which are claimed to arise from dealing with the issue structurally.

Those who are familiar with the issues in telecommunications regulatory policy will find nothing new in this book. It is also not sufficiently wide in scope to work as an effective primer on the subject. The pity is that the telecommunications regulatory regime is failing us, and that failure rests with the excessive reliance on the role of the ACCC as a price setter; but this book does not make a persuasive case for change. Its principal failure is that it wants to find the fault in others, rather than in the way that Telstra has managed the regime.

Perhaps the way to solve the impasse is to find a modern day Heracles to clean out Telstra's Aegean stables of the accumulated detritus of their economic advisers and start with the assumption 'we are where we are because of us, not them.'

ENDNOTES

1 Qantas Airways Ltd [2004] ACompT 9.

2 The reviewer must confess to having been directly involved in the development and marketing of the SPAs, and as Account Director Media being one of a small number in Telstra who worked hard to get the News/Telstra relationship to the point of agreement (though had no direct role in the subsequent structure of the venture). There is a useful discussion of the HFC plans in Frank Blount and Bob Joss, *Managing in Australia*.