



**Australian
Competition &
Consumer
Commission**

Australian Competition and Consumer Commission (ACCC)

*Submission to the DCITA review of the universal
service obligation (USO)*

November 2007

Table of contents

Executive Summary	2
1. Introduction	4
2. How universal service can affect the telecommunications access regime	5
2.1 Benefits of competition	5
2.2 Interaction between the access regime and universal service	6
3. Protecting consumer benefits	8
3.1 Clearly defining the universal service obligation.....	8
3.2 Measuring costs and revenues.....	9
4. Introducing contestability to the provision of universal service.....	11
4.1 Using market forces to determine the universal service subsidy	11
4.2 Previous efforts to introduce contestability.....	12
4.3 Competitive tender	12
4.4 Per-service subsidies	13

Executive Summary

The ACCC welcomes the opportunity to provide comments on the universal service regime in response to the Issues Paper from the Department of Communications, Information Technology and the Arts (DCITA).

The aim of universal service policy is to ensure that all Australians have reasonable access, on an equitable basis, to a telecommunications service. Universal service can be achieved through a variety of mechanisms. Throughout this submission, references to universal service are a reference to this policy goal, rather than to the particular mechanism used to achieve it in Australia to date, namely the imposition of a universal service **obligation** on one or more providers. This submission recognises that universal service is the relevant policy goal, and its achievement does not necessarily require the imposition of an obligation on one or more carriers.

While the ACCC has no direct role in the administration of universal service, it is making a submission to highlight the interaction between universal service policy and those aspects of competition policy that deal with access to bottleneck services in telecommunications.

The telecommunications access regime—as set out in Part XIC of the *Trade Practices Act 1974* (TPA) and administered by the ACCC—plays a significant role in the telecommunications policy framework and delivers the benefits of greater competition to consumers through lower prices, greater product innovation and improved service quality, as well as ensuring any-to-any connectivity and ongoing efficient investment in telecommunications infrastructure.

The ACCC recognises that infrastructure roll-out and competition are not likely to emerge evenly in all areas. This was explored in the ACCC's 2006 position paper *A strategic review of the regulation of fixed network services*, which stated that there is a need for the regulatory framework to reflect this market dynamic. The principles underlying universal service are consistent with this view by ensuring that services are provided in areas which may not otherwise be supplied with services on a commercial basis.

However, the design of universal service policy has the potential to come into conflict with the government's competition goals and associated consumer benefits. For example, Telstra recently argued that wholesale prices for access to its network should be increased to compensate for what it believes to be an inadequate subsidy for its universal service obligations. In essence, the access regime acted as a quasi-review mechanism of the Minister's subsidy determination, with the ACCC and Australian Competition Tribunal being asked to evaluate its adequacy. As the Tribunal noted, to the extent Telstra was not adequately compensated for fulfilling its obligations, it has legitimate claims that this be considered in the context of access pricing. However, this creates some risk of deleterious effects on competition and associated consumer benefits.

The preferred option for avoiding these issues would be to introduce contestability to the provision of the universal service. Enabling a number of carriers to contest for the provision of universal service provides greater opportunities for market forces to determine the appropriate size of the universal service subsidy. Further, the voluntary nature of service provision under contestability removes the ability of carriers to subsequently contend that subsidies are insufficient. Contestability could be introduced through a tender for the provision of services across a wide region—as used recently for broadband services under the Broadband Connect initiative—or through per-service subsidies enabling consumer choice.

Other partial solutions considered in this submission relate to less significant changes from the existing overall approach to universal service, and would be appropriate if the government believed that Telstra was the only feasible universal service provider.

First, the design of the current universal service arrangements makes an accurate determination of the cost of providing universal service difficult. It is difficult to determine exactly how many universal services there are in Australia, or where they are located. Increasing the degree of specificity in the universal service obligation would not end debate as to the cost of universal service, but could place clearer boundaries around such debate.

Second, the current process of using trend analysis for estimating the net cost of fulfilling the universal service obligation does not provide as reliable estimates as more detailed methods for measuring the net cost (taking into account revenues). For the coming years, the application of any net cost measure of an appropriate subsidy amount will need to recognise, and account for the potentially significant revenue impacts of alternative subsidy programs such as Broadband Connect and the Communications Fund on the universal service provider's ability to generate revenues in universal service areas.

To the extent that these suggestions are adopted, the ACCC believes that a well-designed universal service policy can function as an effective safety net to complement the consumer benefits that are delivered through the competition framework.

1. Introduction

Universal service policy is aimed at ensuring that all Australians have reasonable access, on an equitable basis, to standard telephone services and payphones. This has the effect of bringing services to areas in Australia for which it is not profitable for a service provider to do so.

Telstra is currently the sole universal service provider of standard telephone services. Telstra is compensated for the net cost of fulfilling its universal service obligations in loss-making areas through a subsidy. All carriers in Australia contribute to the fund based on their share of eligible revenue.

The size of the universal service subsidy is determined by the Minister following advice from the Australian Communications and Media Authority (ACMA). The size of the subsidy is meant to reflect the cost of providing non-commercial services, minus any revenue that the universal service provider receives.

The ACCC does not have a direct role in administering universal service policy. The ACCC has a statutory role in promoting competition, any-to-any connectivity and investment in the telecommunications industry. The ACCC has long recognised that infrastructure roll-out and competition are not likely to emerge evenly in all areas. This was explored in the ACCC's 2006 position paper *A strategic review of the regulation of fixed network services*, which agreed that there is a need for the regulatory framework to reflect this market dynamic. Universal service policy is consistent with this because it promotes the provision of services in areas where they would not be supplied on a commercial basis.

The ACCC has made a submission to the review because of its obligation to promote the long-term interest of end-users, including through the promotion of competition. Where restructuring the universal service arrangements has implications for the competitive delivery of services and the development of competition, it is clearly consistent with the ACCC's objectives to contribute to this review process.

The ACCC would welcome the opportunity to comment further on any specific proposal or sets of proposals put forward by the government as the review progresses.

The submission is structured as follows:

- Chapter 2 discusses the ways in which universal service policy may come into conflict with the government's competition goals and associated consumer benefits.
- Chapter 3 outlines ways in which consistency between universal service policy and competition policy can be improved.
- Chapter 4 considers options for the introduction of contestability to the provision of universal service, and the use of market forces to determine the size of the universal service subsidy.

2. How universal service can affect the telecommunications access regime

The ACCC administers the telecommunications access regime laid out in Part XIC of the TPA. The access regime aims is designed to promote the long term interests of end users through improving competition. Competition is enabled through regulated access to enduring bottlenecks in telecommunications infrastructure.

This section will describe the ways in which this access regime has benefited consumers and how this may be affected by the design of universal service policy.

2.1 Benefits of competition

One of the principal aims of the telecommunications access regime contained in Part XIC of the TPA is the promotion of competitive markets. The legislative framework recognises that competitive markets can promote investment and maximise consumer benefits, in the form of improved service quality, innovation and lower prices over the long term.

Since the introduction of the telecommunications-specific provisions in 1997 the industry has developed substantially. Consumers have benefited through improvements in service quality, the introduction of new services, an expansion in service coverage, and the reduction of prices. ACIL Tasman recently estimated that the Australian economy was around \$15.2 billion larger than it would have been had the 1997 reforms and other subsequent developments not occurred.¹ A key reason for this has been the 31 per cent reduction in the price of telecommunications services since 1997-98.²

Recent developments demonstrate that competition policy is continuing to produce significant consumer benefits. Competitive pressure is driving 3G network upgrades by the four mobile network owners, with Telstra extending the reach of its NextG network to a claimed 98.9 per cent of the population. These network upgrades are providing terrestrial-based broadband services in addition to voice services to much of the population for the first time. Mobile subscribers have also benefited recently with the introduction of bucket or capped plans, in which calls are not charged on an individual basis unless a capped amount is exceeded.

Competition is also forcing fixed network operators to upgrade their networks in order to capture a share of the flourishing demand for broadband services:

- The entry of Optus into DSL broadband in 2004 led to Telstra slashing entry-level broadband prices to \$29.95 in response to competitors. Optus has recently introduced its 'Fusion' entry-level broadband and phone cap for \$69 and Telstra is responding.

¹ ACMA, *Communications Report 2005-06*, p.10.

² ACCC, *Telecommunications Competitive Safeguards for 2005-06* p.79

- Competitors accessing Telstra's network via the regulated Unconditioned Local Loop Service (ULLS) and Line Sharing Service (LSS) were the first to introduce ADSL2+ technology in Australia.
- Around 91 per cent of the population are now connected to local exchanges offering ADSL or ADSL2+ peak speeds ranging from around 1.5Mbps to 20Mbps. Telstra has the capability to provide ADSL2+ to approximately 87 per cent of Australian homes.
- Telstra's fibre-to-the-node (FTTN) proposal emerged as the number of ULLS and LSS-based competitors grew.

These indicators suggest that competitive market forces have driven, and will continue to drive improvements in prices, infrastructure and services.

2.2 Interaction between the access regime and universal service

While the ACCC has no direct role in the administration of universal service, this submission is intended to highlight the interaction between universal service policy and the part of competition policy that deals with access to infrastructure in telecommunications.

Despite the differing purposes of the telecommunications access regime and universal service policy, the two have the potential to interact with the other and care needs to be taken to ensure each policy complements the other in the way it delivers benefits to consumers.

As the universal service provider, Telstra has a legitimate interest to ensure that it is adequately compensated for fulfilling the universal service obligation. The question of the adequacy of compensation, however, can be brought to bear in the context of access pricing.

When determining the terms of competitor access to essential facilities under Part XIC, the ACCC is required to weigh up and balance several legislative criteria. One of these criteria is the legitimate business interests of the access provider, which include the ability to recover infrastructure costs and a return its investments. In effect, this allows access providers an avenue of quasi-merits review of other government programs such as universal service. If an access provider is incurring excess costs on a particular piece of infrastructure as the result of a government imposed obligation that is not fully funded, then it is open for the access provider to argue that the ACCC should have regard to this alleged shortfall when setting terms of access.

This situation arose most directly in 2006 in the context of the ACCC's assessment of Telstra's undertaking in relation to its supply of the ULLS.

The ULLS is a key access service which allows competitors to supply ADSL/ADSL2+ and fixed voice services from their own equipment in Telstra exchanges. However, the ULLS is typically only used in areas with high population densities. Prices for the ULLS have traditionally been based on a banded pricing structure that reflects the different costs of providing the service in CBD, metropolitan, regional and rural areas.

However, Telstra submitted two undertakings in December 2005 that proposed to offer the service at a price of \$30 per service per month, regardless of the geographic area in which the service was acquired. Telstra had, prior to submitting this undertaking, requested the Minister to issue a determination instructing the ACCC to price the ULLS on an averaged basis. The Minister declined to issue such a determination at that time.

The ACCC rejected the undertakings in August 2006 because it was unable to be satisfied that they were reasonable. Specifically, the ACCC concluded that the undertakings would not have promoted competition, would not encourage the efficient use of and investment in infrastructure and would result in Telstra recovering more than was necessary to promote its legitimate business interests.

Telstra subsequently challenged the ACCC's decision in the Australian Competition Tribunal. It supported its contention that ULLS prices should be geographically averaged during this appeal by reference to an alleged shortfall in universal service funding, despite there being no direct link between the ULLS and universal service.

The Tribunal concluded that:

Averaging would not be in Telstra's legitimate business interests in the presence of a [universal service fund] that fully compensated Telstra for losses it made in rural areas on the account of the [retail price parity obligation].

It also stated:

We consider it is to the point for Telstra to argue that the contribution it receives from the [universal service fund] does not adequately compensate it for its losses in complying with the [retail price parity obligation] in the provision of retail line rental services in rural areas, when considering whether averaged charges are in Telstra's legitimate business interests.³

The ACCC and Tribunal assessed the undertaking by reference to a range of criteria, of which the access provider's legitimate business interests was one. The Tribunal ultimately found that price averaging may have been in Telstra's legitimate business interests if the universal service subsidy was inadequate. However, there was insufficient evidence to substantiate a shortfall in universal service funding on this occasion, or that increasing access prices as a remedy was a reasonable solution in all the circumstances.

Had the undertaking been accepted by the Tribunal, there could have been significant medium to long term effects for consumers. As the ULLS is generally only acquired in densely populated areas, the new pricing structure could have had considerable consequences for ULLS-based competition in Australia. This could have stalled or even stranded infrastructure investment by other ADSL/ADSL2+ providers, with flow-on effects through increased retail prices for telecommunications services, and a reduction in the range of services available.

In effect, the access regime acted as a merits review of the Minister's determination of the level of universal service subsidies. As this experience demonstrates, independent scrutiny of universal subsidy determinations have occurred, and could be expected to continue if the universal service framework remains in its current form.

³ *Telstra Corporation Ltd (No 3)* [2007] ACompT 3, [229]-[230]

3. Protecting consumer benefits

As demonstrated in the previous chapter, competition policy can be affected where parties are able to use the access regime as a vehicle for quasi-merits review of the Minister's subsidy determination. Where no significant changes are contemplated to the existing approach to universal service, the ACCC considers that several options should be considered for addressing this issue.

3.1 Clearly defining the universal service obligation

It is difficult to evaluate the true cost of providing universal service while there is a universal service obligation that is not clearly defined. Increasing the degree of specificity in the universal service obligation would not end debate as to the cost of universal service, but could place clearer boundaries around such debate.

The current universal service obligation gives the universal service provider the ability to define the ways in which they will meet their obligation and, to a degree, the scope of that obligation. This may have some advantages in that it is a light handed regulatory approach that is not overly prescriptive or burdensome and not reliant on one particular technological solution.

However, it is very difficult to accurately determine a carrier's losses from providing universal services if its universal service obligation leaves substantial room for interpretation. This may have been recognised in the DCITA review universal service policy in 2004 when it was stated that 'any subsidy based on modelling results would risk being contested by one or more of the affected carriers, given the range of factors and the nature of the methodological issues involved'.⁴

The standard telephone component of the universal service obligation is currently defined as the obligation 'to ensure that standard telephone services are reasonably accessible to all people in Australia on an equitable basis, wherever they reside or carry on business'.⁵

Many of the key dimensions of the current universal service obligation, such as functionality of the standard telephone service, reasonable access and pricing parity, are left to be defined by Telstra in its USO Standard Marketing Plan or USO Policy Statement. These documents do define these concepts to some extent, but the documents act more as guidelines than proscriptive obligations.

The end result is that there is no definitive answer to the question of how many services are provided under the universal service arrangements, or where they are located. While any universal service obligation is defined without a high degree of specificity, there will always be scope for debate over whether the universal service subsidy is adequate.

⁴ Ibid

⁵ *Telecommunications (Consumer Protection and Service Standards) Act 1999*, section 9.

3.2 Measuring costs and revenues

A key implication of the current arrangements, which only recognise one carrier as a potential universal service provider, is that it is necessary to measure the net costs of providing universal service in order to determine an appropriate subsidy.

As the current universal service provider, Telstra has legitimately sought to ensure that it is appropriately compensated for fulfilling its obligations. Measuring the costs of these obligations is clearly an important part of setting an appropriate level of compensation.

Detailed measurement of the net cost has not occurred since 2000. Since then, the subsidy amount has been determined by adjusting each year's amount based on trends in underlying factors. The 2004 DCITA review of universal service policy argued that trend analysis offered a less reliable estimate of the net cost of universal service provision than if it was estimated through a detailed cost measurement process.

The DCITA review also suggested that any new attempts to measure the costs of universal service in detail would be difficult, controversial, costly, and take a minimum of two years.⁶ The review determined that the problems and costs associated with developing a new model might outweigh the potential benefits.

However, the longer the government uses a trend-based measure of the net costs of universal service, the greater the prospect that questions about its adequacy will arise, with possible consequences for the access regime and competition.

While the focus of determining appropriate subsidies is generally on costs, changes in revenues associated with universal service must also be considered. Subsidy programs such as Broadband Connect and the Communications Fund are intended to underwrite the provision of adequate services to regions which may significantly overlap universal service areas.

In the coming years, these subsidy programs will have important implications for assessing revenues relevant to any universal service subsidy determination, including that:

- they may limit the ability of the universal service provider from earning additional revenues to help meet its costs by expanding into broadband and other services and
- as telecommunications services converge, networks subsidised to provide broadband may increasingly come to compete directly with the universal service provider in the provision of voice services.

Any future determinations of an appropriate subsidy for universal service will clearly need to address these issues.

Should the government prefer more substantial reforms to universal service arrangements to avoid the cost measurement issue, an alternative would be to use

⁶ Department of Communications, Information Technology and the Arts (DCITA), *Review of the operation of the Universal Service Obligation and Customer Service Guarantee*, 2004, page xiv.

market forces to determine the size of the universal service subsidy through competitive bidding. This is discussed in Chapter 4.

ACCC input

The ACCC undertakes cost modelling exercises as part of the administration of the telecommunications access regime. However, there are a number of reasons why the cost models currently being developed are unsuitable for use in the assessment of universal service subsidies.

One relevant issue is that the ACCC's fixed network model will have no mechanism to calculate expected revenues, which has been a key consideration when attempting to estimate the universal service subsidies. Further, the ACCC model is specifically focussed on costing and technology issues that arise in the context of access pricing disputes. This is more pertinent to regions that are less likely to need to rely on universal service provision.

However, if the government's preferred approach to universal service necessitates the measurement of costs, the ACCC would be happy to discuss further how it might assist.

4. Introducing contestability to the provision of universal service

As noted in Chapter 3, accurately compensating the universal service provider(s) for its universal service obligations will help preserve the ability of competition policy to deliver benefits to consumers. Under arrangements whereby the obligation is placed on one universal service provider, the subsidy generally needs to be determined following a process for measuring the net cost of providing universal service.

However, a preferable method for ensuring that universal service policy is consistent with competition policy is by determining the universal service subsidy through market forces. This chapter explores how this may be achieved by introducing contestability to the provision of universal service.

4.1 Using market forces to determine the universal service subsidy

Imposing an obligation to supply universal service on a firm can lead to lengthy debates around cost measurement. Therefore, it may be useful to investigate the use of market mechanisms to determine the cost of providing universal service. In a competitive environment, market forces can be used to assist in identifying a level of subsidy that most closely reflects the actual net cost of providing the service.

Effective use of market mechanisms in determining the subsidy can;

- minimise the subsidy by encouraging the provision of universal service over more efficient networks;
- help to overcome the information asymmetry problems that arise when a regulatory body seeks to independently estimate these costs;
- help place a value on the intangible benefits that a carrier receives when it is the universal service provider;
- allow the government and regulator to avoid the high cost of developing cost models.

Market-based approaches to determining the cost of universal service can be pursued through some form of contestability. Where there is actual or potential contestability in the supply of services, competitive tendering or direct competition for per-service subsidies could be used to help determine the necessary level of public support necessary to provide universal coverage. Use of these mechanisms would decrease the importance of any attempt to model the cost of universal service, minimising the issues which may arise in such a process.

While market-based processes can be used as an alternative to measuring universal service costs, they can also be used in combination. An estimate of the subsidy using a financial study can provide a check of whether the competitive process is producing an

appropriate result. A cost measurement process may also be required if the government wishes to set maximum subsidy levels available through the competitive process.

4.2 Previous efforts to introduce contestability

The government trialled a universal service contestability program in 2001. Under this pilot program, carriers could nominate to be a universal service provider in one or both of the two nominated areas and would receive a set subsidy for each customer they supplied in that area. Carriers were required to supply any individual requesting a service within the nominated area, which meant that potential competitors were required to have a network capable of supplying every individual within the area. No carrier nominated to become a universal service provider under this scheme.

There are a number of reasons to believe that it is more likely that alternative carriers would nominate to become universal service providers under a new contestability scheme. This is primarily due to technological and market developments since 2001. New high speed wireless technology has emerged in the past five years. Further, government support for the OPEL WiMAX and transmission rollout means that there is and will be considerably more alternative infrastructure in regional areas than during the contestability pilot program. This means that Telstra's copper network may not be the only network capable of delivering standard telephone service in a number of regional areas.

The universal service contestability experience in the United States provides some support for the proposition that recent technical developments can lead to increased universal service contestability. Contestability was introduced to the US universal service fund in 1996. As of 2002, competing providers received only \$15 million of a \$3 billion universal service fund. After 2002, as wireless competition began to emerge, the subsidy provided to competing providers grew at an annual rate of over 100 per cent, reaching almost \$1 billion in 2006. While the US universal service fund system is not without flaws, this development demonstrates the increasing ability of wireless technologies to deliver universal telephony services.

Further, a differently designed contestability arrangement may be more likely to attract competitive entry.

4.3 Competitive tender

One possible process for using market forces to determine the necessary level of universal service funding could be a government instigated tender process for the provision of services in universal service areas. This would be similar to the recent Broadband Connect process.

The government would set a minimum standard of service and request bids from carriers. If fully effective, the process would see carriers submit bids that involve a subsidy that reflects the cost of providing the service (including a normal rate of return). The owner of the most efficient network should win the tender process by virtue of its lower costs. The winner of the tender would then be provided with the

requested level of subsidy, if any, in order to provide services. Under this model, there would only be one universal service provider in each universal service area.

This process could be run as one large national tender or a number of smaller tenders for the provision of services in particular geographic areas. While it may be easier to capture economies of scale if the tender covers a larger geographic area, tenders for smaller areas open up the process for smaller carriers.

The ACCC recognises, however, that there are some practical difficulties associated with operating a tender for the provision of services in areas where services are already being provided. One issue is that the incumbent provider is in a strong bargaining position due to its existing sunk network and its bid will probably not need to represent its fully allocated cost of service provision to be successful.

Another issue is that there would be some difficulty in determining which specific areas should be the subject of the tender. The universal service scheme is aimed at providing access to services where such services would not otherwise be supplied on an equitable basis. Determining exactly which areas are unprofitable to supply on reasonable terms may be a difficult undertaking, although a somewhat similar process involving the determination of under-served areas was successfully engaged in as part of the Broadband Connect tender.

Competitive tender processes generally work better where there is no pre-existing monopoly infrastructure provider already in the area. It is less clear that a tender process would work successfully when applied to a service which is already being supplied. However, if the practical difficulties associated with a universal service tender can be worked out, a competitive tender could be one way to value the cost of providing universal service.

4.4 Per-service subsidies

A per-service subsidy scheme is another way in which market forces could be used to determine the cost of universal service.

This type of arrangement would permit multiple carriers to be registered as universal service providers in the one area. These carriers are likely to be wireless network and/or satellite operators, in addition to Telstra with its existing infrastructure. The carriers would then compete for customers and receive universal service subsidy payments based on the number of customers they serve.

A per-service subsidy scheme differs from a competitive tender in a number of ways. Firstly, there are number of carriers providing universal service in an area, rather than just the one carrier that won the tender. Secondly, consumers get to choose which carrier provides the best service, rather than the government choosing the provider that then serves all users in the area. This means that neighbours may choose to be with different providers.

In effect, a per-service subsidy scheme would involve competition between carriers *within* universal service areas, while a competitive tender would involve competition

for exclusive provision in certain areas. Examples of a per-service subsidy scheme are the model adopted in previous attempts at universal service contestability, and the HiBIS initiative for broadband funding.

The level of subsidy that would be provided to a carrier supplying an individual service would be set through a reverse auction process, whereby the lowest bid wins the right to provide the service or sets the subsidy level. If fully effective, the process would see carriers submitting bids that accurately reflect the cost of providing the service. The carrier able to supply each service at the lowest cost would win each auction by submitting a bid that required the lowest subsidy. As a result, the total universal service subsidy would accurately reflect underlying services costs for the most efficient network(s).

This arrangement differs from the contestability pilot program in that carriers are not required to build a network capable of supplying every service within a large universal service area. This means that alternative providers are more likely to apply to become universal service providers as the financial risk in building a network large enough to service all users in an area in order to obtain an uncertain subsidy level—as was the case with the pilot program—may have been sufficient to discourage any competitive entry. This is likely to be important for wireless network operators for whom technological limitations may mean it is difficult to guarantee coverage to all premises within a particular area.

A per-service subsidy scheme as outlined here permits alternative providers to slowly expand their network and avoid the large economic risks associated with full scale entry. While there is no certainty that a new per-service subsidy scheme designed along these lines would attract competitive entry, advances in infrastructure development and technological change since the early 2000s means that a new universal service contestability scheme is more likely to attract competitive bids than was previously the case.