TELECOMMUNICATIONS UNIVERSAL SERVICE OBLIGATION

DRAFT REPORT

SUBMISSION BY VODAFONE HUTCHISON AUSTRALIA

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Introduction

Vodafone Hutchison Australia (**VHA**) welcomes the opportunity to provide feedback on the Productivity Commission's Telecommunications Universal Service Obligation (**USO**) Draft Report.

VHA strongly supports the key conclusions of the Commission's Draft Report, which has produced a damning set of findings and a practical set of recommendations. The Draft Report demonstrates a thorough understanding of the issues and proposes a sensible path forward to fundamentally reform the USO for the digital age.

In this submission we have focused our comments as narrowly as possible and provided additional evidence in support of key points. The broader issues and viewpoints raised in VHA's earlier submission to the Issues Paper remain significant and relevant to the Draft Report.

The Draft Report has for the first time shed some light on the USO arrangements. They remain however extremely opaque considering the billions of taxpayer and industry subsidies at stake. It is extraordinary that the current USO arrangement have not placed any transparency or accountability obligations on Telstra. The lack of transparency is particularly concerning, with no requirements for Telstra to report on the number of non-commercial services it provides nor the costs of services supplied under the USO.

VHA is very concerned by the perverse incentives created by the current USO which the Draft Report has revealed and the implications of this, especially for rural and regional Australians. The current USO appears to provide exactly the opposite incentives to its stated intention. Telstra's funding is fixed and guaranteed at $297 million per annum over the life of the Telstra USO Performance (**TUSOP**) Agreement, however there is no obligation to actually maintain the services the USO is intended to guarantee. Telstra's incentive therefore is to shut down as many services as possible as quickly as possible in order to reap a larger and larger windfall through a subsidy from taxpayers and Telstra's competitors. The Commission identifies that this does appear to be happening in practice as a substantial number of copper lines and payphones have in fact been shut down. The fact that the ACMA reported 17,500 payphones in June 2015, but Telstra currently reports 16,800 payphones[1], seems to indicate that the shutdown of USO funded infrastructure is taking place at a rapid rate, and therefore the

[1] https://www.telstra.com.au/consumer-advice/payphones as at 2 February 2017.

subsidy to Telstra is rising at the expense of Australian consumers, particularly rural and regional Australians.

VHA is also very concerned by the anti-competitive implications of the current USO. Not only does it not safeguard the infrastructure it was intended to support, it raises substantial barriers to investment in competing infrastructure which could and should deliver reliable substitutable or complementary services for rural and regional Australia. In light of the Commission's findings, our submission focuses on the significant negative impact on competition in rural and regional areas of continued USO subsidies to Telstra which serve to entrench and extend Telstra's dominance, subsidise its investment in commercial services including its regional mobile network, and make it exponentially more difficult for other companies to invest in infrastructure.

Our submission includes indicative modelling conducted by Frontier Economics which illustrates the impact of a range of subsidy levels that Telstra could be receiving from USO subsidies. Using a range of indicative estimates of the subsidy level potentially delivered to Telstra under the current USO arrangements, Frontier illustrate the extraordinary subsidies which are likely to be flowing to Telstra - potentially <u>between $729 million and $2.2 billion over the life of the TUSOP Agreement</u>.

Redirecting these funds to other projects could deliver substantial benefits to rural and regional Australians. For example, assuming a 50 percent average subsidy over the remaining years of guaranteed USO funding, <u>the excess funds to be paid to Telstra could deliver 14, 356 kilometres of additional highway mobile coverage or more than 2,000 new mobile base stations in rural and regional areas.</u>

While we accept the fundamental notion that there is a significant social and economic benefit in ensuring a base level of communications services for all Australians, it is clear that the current scheme does little to deliver this. Any ongoing or new USO arrangements must be transparent, targeted, efficient and carefully designed to ensure that they are competitively neutral.

The Draft Report proposes establishing a funding program for a form of community telecommunications service for locations where premises are without a satisfactory alterative voice service, such as indigenous communities. We believe that any such program should be consistent with the findings of the 2015 Regional Telecommunications Review and involve the establishment of a flexible, technology-neutral fund. The Government should periodically consult with industry and the community to identify the most effective use of those funds to ensure that technological advancements and consumers' needs are taken into account. One of the key principles of allocation from the fund would be ensuring the preservation and promotion of competition. We support the Draft Report's recommendation of a stocktake of all current telecommunications programs that share universal service objectives in order to improve efficacy and cost-effectiveness.

The Australian Government's Mobile Black Spot Program is strongly supported by VHA , however as we argued in our submission to the Issues Paper, there is a real risk that without necessary, urgent adjustments to its implementation arrangements, it risks becoming another mechanism through which taxpayer funds further entrench Telstra's dominance in regional and rural areas. An improved Mobile Black Spot Program, with greater incentives and obligations for infrastructure sharing, increased co-investment, and subsidies for not only capital expenditure but operating expenditure particularly for backhaul access, can significantly improve regional mobile coverage in an efficient and competitive manner. NBN Co. can play a substantial role in facilitating such schemes through the provision of lower-cost transmission via its extensive taxpayer funded transmission network, for example.

In light of the Commission's damning findings that the lack of transparency and accountability of Telstra with respect to the USO is having an adverse impact on competition and efficiency, we strongly support the Commission's recommendation that the Government should immediately commence negotiations with Telstra to amend and abolish or substantially reduce the standard telephone and payphone modules of the TUSOP Agreement to the minimum level necessary given NBN's accelerating rollout. Responsibility for delivering the Commission's proposed baseline broadband and voice telecommunications service to all premises in Australia needs to be explicitly transferred to NBN Co. as a priority.

VHA believes that it would be extremely helpful for the Commission to provide clear recommendations to the Government in its Final Report in relation to transitional arrangements and in this submission we have laid out the specific steps the Government should take to adopt the Commission's proposed reforms to the USO as a matter of urgency. As the scope of the Standard Telephone Service (**STS**) USO is set out in the *Telecommunications (Consumer Protection and Service Standards) Act 1999 (Cth)* (**TCPSS Act**), the most direct way of achieving change in a timely manner appears to be legislative amendments. VHA therefore considers the Commission's Option 1[2] is the most appropriate method for transitioning away from the STS USO in its current form.

[2] Information Request 9.1

The USO lacks transparency, is anti-competitive and is entrenching Telstra's dominance

VHA's submission to the Issues Paper outlined the current USO's negative impact on competition for telecommunications services and the significant advantages it provides to Telstra as the incumbent Universal Service Provider (**USP**).

In particular, our submission highlighted that:

- The current USO is outdated and inflexible. It is focused on funding copper network voice services and payphones until mid-2032. All of these areas will not only receive broadband and voice services via the NBN, but the current USO also locks in the delivery of fixed-line voice services despite the growing consumer preference for mobile. Since funding is fixed, but there is no obligation to maintain particular infrastructure, the current arrangements do not even protect the copper and payphone infrastructure they were intended to protect.

- The current USO is a substantial tax on telecommunications services providers and their customers. It taxes smaller players (even if they are loss-making) to subsidise a highly profitable incumbent operator, when it has not even been clearly established which services, if any, are subsidised by the USO nor that there is even a net loss from those services.

- The current USO distorts competition in regional Australia and restricts investment by competitors by heavily subsidising Telstra at the expense of its competitors. This provides Telstra with subsidised sunk cost infrastructure and additional pure subsidies, which give it a clear competitive advantage in deploying further regional infrastructure such as its mobile network.

- The true cost of Telstra providing the current USO is unknown and has never been subjected to detailed public scrutiny. The payments provided to Telstra are likely to significantly exceed its costs. In effect, this provides a significant public subsidy to Telstra, which is also the most profitable telecommunications services provider by an order of magnitude. This exacerbates the monopoly advantages constantly accruing to Telstra in regional Australia.

- The current USO provides Telstra with other direct and indirect benefits not available to its competitors, which have never been taken into account in assessing the true net cost (cost less benefits) of the USO. This includes economies of scale and scope in regional telecommunications investment, advertising on subsidised payphones, the provision of the proprietary Telstra Air Wi-Fi service (again on subsidised payphones), and brand benefits from being seen as the ubiquitous provider of telecommunication services. In other jurisdictions, great care has been taken to subject the costs and benefits to substantial public scrutiny to ensure that the true net costs of the USO are identified, and the incumbent is not over-compensated.

USO funding harms competition in mobile markets

VHA notes the Commission has been unable to accurately estimate the true cost of the USO subsidies, given the opacity of how the subsidy has been derived and because the USO payments are not linked to numbers of subscribers protected by the USO[3]. In this submission, we explore why the negative impacts of these ongoing payments are potentially substantial, undermining the ability of other companies to invest in competing infrastructure which would substantially benefit rural and regional Australians.

Telstra receives large subsidies to supply a STS in all areas of Australia, including not only those areas for which it may not choose to supply a service commercially, but also areas where a service would be supplied in any event. The subsidies received are fixed with respect to the numbers of users. Even if it were to be accepted that the current USO does not contain any direct windfall subsidies to Telstra (which does not appear to be the case), the present USO funding model creates serious distortions to competition for two major reasons:

a) The funding model, based on eligible revenues of carriers and carriage service providers, taxes the marginal revenues of suppliers. For each dollar earned, around 0.5 cents is lost to the USO fund. This reduces benefits from attracting customers from other suppliers and so lessens the intensity of competition. As the Commission has observed, *"...as a non-contestable obligation given to one provider and partly funded by other providers, it effectively stymies competition."* Although 0.5 percent appears to be a small impact, this will have a very material impact on finely balanced investment decisions in precisely the marginal areas that the USO is intended to support.

b) There are material economies of scope between mobile and fixed networks since both networks share the same core, transmission and exchange infrastructure.

Of the two effects, the second is likely to be the most significant. The USO is likely to substantially lower the incremental cost of investment decisions as investments made in infrastructure to serve fixed voice services also lower the incremental costs of supplying mobile services.

[3] Draft Finding 3.1

In other words, when VHA wishes to expand its network in higher-cost rural areas, it has to consider the likely recovery of the full operating costs plus the full capital costs of deploying new infrastructure. Telstra faces operating costs plus only the incremental capital costs – likely to be in areas where there is already considerable excess capacity. This applies to infrastructure such as land, exchanges and other building equipment as well as core network equipment, and the transmission network, all of which is shared between fixed and mobile networks.

Of particular concern is the USO payments offsetting part of Telstra's costs of delivering transmission backhaul capability to regional areas. As noted in our submission to the Issues Paper, since the current USO subsidises Telstra's copper and payphone network it also effectively subsidises Telstra's transmission network. Telstra requires a transmission network to supply fixed line services and payphones. It can also use this transmission network to supply backhaul for transporting data between Telstra's mobile towers and its core network. By contributing to the costs of its backhaul capacity, the current USO provides Telstra with a strong advantage in providing mobile services in regional areas where other operators lack significant backhaul infrastructure. For other operators to compete with Telstra in these areas, they would have to incur the costs of backhaul investment that Telstra has already incurred as a result of its USO obligations and funding.

The fact that the ACCC reduced the price of regulated regional Ethernet transmission services on Telstra's network (**DTCS**) by 78 percent in April 2016 is also strong evidence that Telstra not only has substantial advantages in utilising its transmission network which has been subsidised by the USO, but is also raising substantial barriers to entry to other companies through charging unreasonably high wholesale transmission prices.

Moreover, once Telstra has been able to utilise its subsidised backhaul capacity to launch its first mobile tower in an area, that 'beachhead' site can form the base for a local microwave transmission network that can enable other towers in the vicinity to utilise the same backhaul. In this way, backhaul capacity that was originally subsidised through the USO can and does facilitate Telstra's expansion of mobile coverage across regional areas at exponentially lower cost than any other company. This makes it extremely difficult for other mobile operators to compete on equal terms.

This effect is important and is amplified by the fact that cost recovery can be challenging in these areas. Telstra's submissions in relation to the current ACCC domestic mobile roaming inquiry make this clear:

A report from international consultants Ovum makes clear that: Telstra essentially absorbs the cost of the coverage it provides in the most remote areas (including many small communities and extensive highway coverage) to retain its leadership position[4].

And further that:

Ovum finds that in areas it reviewed where Telstra is currently the only network operator, over 65 percent of sites have revenue insufficient to recover the operating and capital costs[5].

While this is clearly not the only relevant factor in investment, the USO subsidies received by Telstra clearly give it an unrivalled advantage in establishing, entrenching and extending its natural monopoly. Without a similar source of funds and economies of scale and scope handed to Telstra by the USO, competing infrastructure providers including mobile providers have much higher incremental costs and are prevented from being effective competitors given the link between coverage and subscribers in metro areas. Consumers living in or travelling through Telstra's natural monopoly coverage area have no choice and therefore suffer in terms of poorer quality of service and higher prices. Consumers in non-rural areas who value coverage, face diluted competition, have less choice and, due to Telstra's high uniform pricing, incur the costs of regional monopoly through a "spill over effect". It is therefore apparent that to the extent Telstra utilises USO subsidies to supply fixed services, it gains a host of benefits that spill over into other services, stifling competition across the board.

Other forms of regulation cannot correct the numerous problems created by the lack of transparency, controls and accountability in the current USO. For example, the ACCC's declaration of transmission services does not take account of the economies of scale and scope afforded to Telstra by the USO nor the direct subsidies which appear to be driven by the USO. Progress in these areas has often been slow, and doubt remains about the true cost-reflectiveness of the charges and the extent to which they reflect the investment incentives facing Telstra in regional areas.

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[4] Telstra, Summary of Telstra's submissions on mobile roaming, p. 3 (https://www.accc.gov.au/system/files/Telstra%20submission%20summary1_0.PDF)

[5] Ibid

USO funding arrangements overstate the net costs

The USO subsidies comprise an annual payment of $297 million, with $44 million directed to subsidising payphones and $253 million for the supply of the STS. These payments last for 20 years and assuming a discount rate of 8 percent, deliver Telstra close to $3 billion.

The Commission has already noted the alarming lack of transparency in the relationship between this payment and the net costs of delivering USO services[6]. As to how the number was originally calculated, there can be little doubt that it was only ever a "ballpark" figure derived from a negotiation rather than a serious net cost assessment. The then Department of Broadband, Communications and the Digital Economy has even acknowledged that it did not have the independent costing work at the time of the negotiation, conceding that the negotiation and the costing work happened in parallel[7].

It is curious that the Department maintained that it was satisfied that it struck a good deal, even though it conceded it had very little idea about the actual costs of delivering services. It is similarly curious that the Department considered that they negotiated a "minimum price" given that the USO arrangements locked in pricing at the top of the estimated range provided by the Department's own expert report:

> *As to the actual cost of delivering them, all I can say is that the negotiations with Telstra were very difficult. Whether there is a margin in there for Telstra I simply do not know. Telstra would not tell us and they did not tell you. Nobody else knows, so I cannot answer your question definitively. All I can say is that we did our best to negotiate a minimum price and we had some independent reassurance[8].*

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[6] Draft Finding 3.3

[7] The Senate Environment and Communications Legislation Committee, Report on Telecommunications Universal Service Management Agency Bill 2011 [Provisions] Telecommunications Legislation Amendment (Universal Service Reform) Bill 2011 [Provisions] Telecommunications (Industry Levy) Bill 2011 [Provisions], February 2012.
At 2.26, DBCDE is quoted as follows: "To provide us with some reassurance that the numbers that we were discussing with Telstra were in a realistic ballpark we commissioned some independent costing work during the negotiations, which was published in the middle of [2011]. The negotiations and that analysis essentially happened in parallel, so at the time we were not informed about the numbers that were being generated by this analysis."

[8] Ibid.

As described above, the USO payments were the result of a negotiation, not a detailed costing exercise. In an environment where the government of the day was desperate to strike a deal with Telstra to cooperate with the NBN rollout (i.e. not to compete with NBN Co.) and there was an enormous information asymmetry between the parties, it would be astonishing if a negotiation could produce even an approximation of the true net cost of delivering services even at that time. Given that the funding is fixed but Telstra appears able to shut down USO services (and is doing so), then even if the funding was close to the net cost at the time of the Agreement, a substantial subsidy will evolve over the life of the Agreement.

The agreed amount of funding ($297 million per annum) came in at the upper end of range developed by an independent consultant, Castalia. The analysis of net cost that was undertaken and relied on as independent verification was undertaken in a short period of time, based on a series of very high level assumptions and incomplete information. Nevertheless it concluded that the net cost to provide the STS USO during 2009/10 was in the range of $215 million to $262 million. The report estimated that the provision of the payphone USO had a net cost during 2009/10 of $35 million to $48 million. Based on these calculations, the net cost of providing both the STS and payphone component of the USO was estimated to lie between $250 million to $310 million per annum.

There is no question that this costing exercise was undertaken at a very difficult time, as it came in the middle of period of uncertainty about the appropriate methodology for costing network services of the kind required to deliver the USO. Nonetheless, there are a number of reasons to consider that the costing approach used was highly likely to overstate the net cost (notwithstanding some adjustments made).

The two most significant of these reasons where that:

a) The costing relied heavily on an incremental costing exercise that had been developed for the ACCC. This was a long-run incremental cost model – not an avoidable cost model which is more suitable for determining net costs of a USO. The difference is that the model used up-to-date network replacement costs for assets that will likely never need be replaced, and took no account of costs actually incurred. At this time, it was already obvious that the copper network had "seen its day". The Department stated that: *"We are not envisaging that they [Telstra] will be reinvesting in a new network. Rather, they will be maintaining it in its current operating* *condition."*[9] A long run incremental cost model is clearly therefore an inappropriate basis to use to value the net cost of the USO.

b) There was no calculation or independent verification of even the number of net cost lines. Rather, the Department directed Castalia that: *"The STS USO net cost area ("net cost area") is limited to 810,000 copper-based fixed line services in operation."*[10] There is no further reason given for the selection of these services as net cost services or assessment of whether some or all of these lines were in fact profitable. Further, it was to be assumed that: "*The STS and payphone USO services are provided at the above levels throughout Australia on an on-going, enduring basis.*"[11] The model used is a long run model, but it is clear now that the assumptions it was based on were misguided.

There has been, and will continue to be, a material decline in fixed lines over time. The Commission notes that this has already included a 25 percent reduction in fixed lines across the network, and a halving in the number of payphones[12].

As noted in VHA's submission to the Issues Paper, given the high fixed costs of supplying the copper network, the reduction in the number of subscribers has led to rising costs per subscriber (although not necessarily a rising cost overall) and hence, a rising level of USO funding per customer served. The rise in costs will only accelerate over time as more customers jettison their landlines and rely on VoIP via the NBN and/or mobile voice services.

It is also important to note that many of the fixed costs incurred by Telstra would be avoidable if no services were provided – meaning that Telstra may also be a beneficiary of USO reform so long as its avoided costs are greater than the payments it receives from government, industry and consumers.

[9] Ibid., p.21.

[10] Paterson, P. 2011, Net Cost of Meeting the Standard Telephone Service and Payphone Universal Service Obligations, Prepared for the Department of Broadband, Communications and the Digital Economy, June, Castalia Strategic Advisors. (Castalia report), p.1.

[11] Ibid.

[12] Draft finding 3.2.

There are two further points that can be made about the ongoing net costs. The first is that even if the initial 2009/10 estimate (which Castalia was instructed to use of 810,000[13] lines) was accurate, the rollout of the NBN and increases in mobile coverage have reduced this number through substitution. Further evidence suggests that, for example, there were 792,053 voice-only band 4 services in operation (**SIOs**) in September 2007, which are areas where the net cost of serving customers will be highest. By September 2016, this had reduced to only 449,354 voice only lines - a marked 43 percent decline from 792,053 in September 2007[14]. Although there is insufficient information publicly available to precisely correlate the band-4 services with USO lines, there is likely to be a substantial correlation.

The second point is that the calculated cost of Band 4 lines in the Castalia report (based on the ACCC's forward looking cost model) was $63.22 per annum per SIO[15]. By 2015, however, the ACCC's view was that the cost of the same lines was only $43.65 - a 31 percent difference which also accounted for the lower volumes of those lines[16].

Each of these assumptions have a substantial influence on the estimated costs, and all of these assumptions have an influence on the final estimates which are somewhere between cumulative and exponential. Given this, it is clearly essential to ensure great scrutiny, scrupulous transparency and independent verification. None of these however were present in the implementation of the current USO.

USO funding arrangements ignore the significant benefits that flow to Telstra

Since the TUSOP Agreement has never been made public, let alone subjected to detailed scrutiny, it is difficult for any party to fully understand the nature and implications of the current USO, especially the extent to which the subsidies appear to generate a profit for Telstra and an increasing subsidy over time as services are shut down. It is apparent however that the analysis of net costs derived from the costing

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[13] See Castalia report, p.1.

[14] ACCC, Quarterly snapshots of ULLS, LSS and DSL, available at: https://www.accc.gov.au/regulated-infrastructure/communications/monitoring-reporting/telecommunications-reports-record-keeping-rules/quarterly-snapshots-of-ulls-lss-and-dsl

[15] Ibid. pp. 11-12.

[16]https://www.accc.gov.au/media-release/accc-fixed-line-services-decision-leads-to-one-off-uniform-fall-in-access-prices-of-94.

exercise at the time of the negotiation of the TUSOP Agreement with Telstra took no account of the this or the broader benefits that would flow to Telstra as the designated USP.

Given the lack of transparency, we consider there are very good reasons to believe that the net cost of the USO is currently (and will in future be) much less than the current funding of $297 million per annum. Nonetheless, it is challenging to estimate what component of this $297 million constitutes economic profit or rent to Telstra. However, we engaged Frontier Economics to illustrate the potential scale of the subsidy available to Telstra by making some broad assumptions about the percentage of the subsidy that is economic rent, and undertake some simple modelling to demonstrate the order of magnitude of the possible on competition and on alternative benefits that could be delivered to users in rural and regional Australia.

Frontier modelled the impact of a range between 25 percent of subsidy at the lower end, and 75 percent at the upper end. While the 75 percent subsidy appears to be a plausible upper end, 25 percent seems a reasonable lower end given the 43 percent reduction in Band 4 SIOs and the accelerating rate of fixed-mobile substitution.

Using some further analysis of the payments due to Telstra and the cost information revealed through the Mobile Black Spot Program, we can identify that:

- Over the remaining 16 year life of the TUSOP Agreement, Telstra stands to make a further $5 billion (nominal) and $3.7 billion (net present value, when calculated at a 5 percent discount rate, which reflects the low risk of the payments).
- At a rate of 25 percent profit, this means payments are $729 million higher than necessary to provide the service. At 75 percent profit, it means payments are $2.2 billion higher than necessary to provide the service.
- Based on the Mobile Black Spot Program funding, costs of new base stations and new highway coverage vary between $771,500 to $800,000 per base station and $67,500 to $112,000 per km of highway coverage added[17].

[17] https://www.communications.gov.au/what-we-do/phone/mobile-services-and-coverage/mobile-black-spot-program

These figures are summarised in Table 1. The figures in this table indicated that Round 2 Mobile Black Spot Program funding has become marginally more expensive, likely reflecting higher costs as mobile networks are further extended into more remote and less populated areas.

Table 1: Outcomes from the Mobile Black Spot Program

Outcome	Round 1	Round 2
Base stations built	499	266
kms of highway mobile coverage added	5,700	1,900
Cost ($m)	385	213
Per station	**$771,543**	**$800,752**
Per km	**$67,544**	**$112,105**

Source: www.communications.gov.au

Over the last three years alone Telstra has received $891 million in nominal terms through USO funding arrangements.

This has potentially subsidised the further rollout of its mobile network as follows in Table 2 (assuming costs as for round 1 of the Mobile Black Spot Program), for up to 866 mobile base stations and almost 10,000 kilometres of new highway mobile coverage.

Table 2: Existing benefits received by Telstra from USO funding

	3 years funding - 25% subsidy	3 years funding - 50% subsidy	3 years funding - 75% subsidy
Funds accrued ($m)	223	446	668
Base stations able to be built	289	577	**866**
Kilometres of highway covered	3,298	6,596	**9,894**

A further benefit to Telstra relates to the development of Telstra's payphone Wi-Fi network and the USO subsidies provided which have undoubtedly reduced the incremental cost of this investment. Other advantages such as branding and advertising benefits are dismissed as being immaterial in the Castalia report however in other jurisdictions these have been accounted for.[18]

In the UK, for example, in 2006, the regulator calculated the cost of the UK USO as 57-74 million pounds, and the benefits, primarily from advertising on payphones (which can easily be calculated from standard market rates) as 59-64 million pounds. Ofcom concluded that since the costs and benefits were broadly equal, the obligation could be maintained, but no subsidies were required since they would amount to subsidising other commercial services. This exercise has never been properly undertaken in Australia, even though Telstra have extensive branding and advertising on their payphones, sell advertising space at commercial rates, and deploy a proprietary commercial Wi-Fi service on those same payphones.

VHA has sought information on the standard rates for advertising space on Telstra payphones and has calculated that the potential benefit of such advertising space to Telstra could be as high as $164,640,000. This is nearly four times the alleged cost of maintaining loss-making payphones, and would deliver a windfall subsidy as high as $120,640,000 to Telstra even if the cost of payphones is assumed to be $44 million per annum.[19]

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[18] In the UK, the communications regulator (Oftel and its successor Ofcom) adopted a simplified approach whereby the value of brand enhancement has been assumed to be 20 percent of BT's retail expenditure on marketing and advertising. See Ofcom, Review of the Universal Service Obligation, June 2005.

[19] JC Decaux has provided rates for advertising on Telstra payphones as $350 per panel per fortnight. Given that Telstra reports that it has 16,800 payphones, and we assume a minimum of 1 panel per payphone, the value of advertising space is potentially as high as 16,800 x $350 x 28 = $164,640,000.

Redirecting USO funds could deliver substantial improvements to rural and regional Australians

Another way to demonstrate the impact of the current USO arrangements is to consider what could be gained by redirecting excess funds (unnecessary to provide the current USO at no net cost) to other programs that could deliver substantial benefits to rural and regional Australians.

The following tables show estimates of alternative uses for the first year and in total using net present values over the remaining 16 years of guaranteed payments. We have assumed the cost is as per the round 2 Mobile Black Spot Program funding, which is likely to be a better estimate of the costs to be incurred in future programs than for round 1.

The figures provided in Table 4 suggest that at a 50 percent average subsidy over the remaining years of guaranteed USO funding, which would for example:

- Fund 14, 356 kilometres of additional highway mobile coverage (the equivalent highway distance of more than three and a half times between Sydney to Perth at 3,900 kms).
- Provide for more than 2,000 mobile base stations to be built in rural and regional areas.

Under the current USO, this opportunity is provided exclusively to Telstra, enabling it alone to expand regional mobile coverage. Although the majority of this subsidy is provided by taxpayers and Telstra's competitors, there are no protections or constraints that reduce the competitive impact or ensure the public benefit of this infrastructure is maximised.

Table 3: Alternative uses for USO funding – 1 year

<table>
<tr><th colspan="2">Future reallocation – Year 1 of reallocation</th><th>Profit rate = 25%</th><th>50%</th><th>75%</th></tr>
<tr><td colspan="2">Funds available ($m)</td><td>74</td><td>149</td><td>223</td></tr>
<tr><td rowspan="2">At same cost per station, per km as for Round 2 MBSP</td><td>Base stations built</td><td>93</td><td>185</td><td>278</td></tr>
<tr><td>Kilometres of highway mobile coverage added</td><td>662</td><td>1,325</td><td>1,987</td></tr>
</table>

Table 4: Alternative uses for USO funding – 2017 to 2032

Future reallocation – 2017-2032 (NPV at 5%)		Profit rate = 25%	50%	75%
Funds available ($m)		805	1,609	2,414
At same cost per station, per km as for Round 2 MBSP	Base stations built	1,005	**2,010**	3,015
	Kilometres of highway mobile coverage added	7,178	**14,356**	21,534

Establishing a Consumer Communication Fund and reforming the Mobile Black Spot Program

The Commission's Draft Report proposes the potential establishment of a funding program for locations where premises are without a satisfactory alternative voice service, such as a mobile service[20]. This might include for example the funding of payphones for indigenous communities or the provision of a baseline voice service for premises or where it is determined that NBN's satellite voice services do not meet an acceptable baseline standard. As the Commission notes however, there are a number of ways these needs could be addressed more efficiently than via the current USO arrangements. The NBN could extend the boundaries of its fixed wireless footprint as a substitute for satellite (as recommended by the 2015 Regional Telecommunications Review) or, as we noted in our submission to the Issues Paper, mobile coverage could be expanded by improving access to NBN's transmission network and satellite capacity which could be used for backhaul for mobile base stations, for example.

VHA believes that the establishment of any new funding program should be undertaken with great care and transparency to ensure that it minimises any competitive impact consistent with the findings of the 2015 Regional Telecommunications Review and, in particular, its recommended establishment of a flexible, technology-neutral 'Consumer Communication Fund'. The Government should periodically

[20] Draft Recommendation 7.5

consult with industry and the community to identify the most effective use of those funds to ensure that technological advancements and consumers' needs are taken into account. One of the key principles of allocation from the fund would be ensuring the preservation and promotion of competition.

As detailed in VHA's submission to the Issues Paper, the quality and extent of mobile coverage is a major concern of people in regional Australia. With more flexible funding, the Mobile Black Spot Program could be extended and evolve into a model which provides subsidies not only for capital expenditure, but also operating expenditure. This would help lower the barriers to regional mobile network expansion – especially the high cost of transmission services. A share of funds formerly designated for the current USO but no longer utilised for that purpose could be applied to extending and refining this scheme to ensure it is delivering the best outcomes in terms of mobile coverage and competition.

VHA notes the Commission's recommendations in relation to the Mobile Black Spot Program, in particular in relation to the revision of its infrastructure-sharing requirements[21]. Without urgent changes to its infrastructure sharing arrangements, the Mobile Black Spot Program will help to entrench Telstra's dominance in regional mobile services. As noted by the Commission, *"Despite the program having provisions that encourage infrastructure sharing, it is unclear whether these are actually effective."*[22] Indeed it is VHA's experience to date that there is very little infrastructure-sharing between mobile network operators in the deployment of the Program. Under the Program's guidelines, winning bidders are required to make sites available to other operators on preferential terms to reflect the taxpayer subsidy they received. VHA has been enthusiastically offering co-location and nearly half of our round 1 sites will be shared. Unfortunately this has not been our experience when seeking co-location on Telstra's sites. Given that Telstra has now received 75 percent of the funded sites under 1 and 2, a reformed Mobile Black Spot Program, with clearer requirements for infrastructure sharing and co-investment and improved backhaul access and pricing arrangements, is critical if the Program is to deliver its stated objective of improving mobile competition in regional and rural areas.

VHA also believes a domestic roaming declaration by the ACCC would ensure that taxpayers in rural and regional areas get maximum value through the Mobile Black Spot Program. Domestic roaming would mean that there was genuine competition for incremental coverage sites in uneconomic areas.

[21] Draft Recommendation 7.4

[22] See p. 225 of Draft Report

The Commission must recommend a clear transition path for the USO

VHA's analysis presented in the preceding chapters adds to the urgent need for change and supports the Commission's recommended phasing out of the current USO as soon as possible[23]. The Commission must provide clear recommendations to the Government in its Final Report in relation to transition arrangements and in this submission we have laid out the specific steps the Government should take to adopt the Commission's proposed reforms to the USO as a matter of urgency.

VHA supports the Commission's finding that the existence of the NBN means that the objective of universal service can be reframed to provide a baseline (or minimum) broadband service to all premises in Australia, having regard to its accessibility and affordability, once NBN infrastructure is fully rolled out. This encapsulates access to both the internet and voice services, as the internet will increasingly be the medium for voice communication[24].

As noted in our submission to the Issues Paper, VHA supports the 2015 Regional Telecommunications Review recommendation that government, in consultation with industry and consumer groups, should develop a new standard for voice and data. VHA believes that this should be regularly reviewed as technologies and consumer demands evolve.

As the scope of the STS USO is set out in the *Telecommunications (Consumer Protection and Service Standards) Act 1999 (Cth)* (**TCPSS Act**), the most direct way of achieving change in a timely manner is via legislative amendments. VHA therefore considers the Commission's Option 1[25] is the most appropriate method for transitioning away from the STS USO in its current form.

As discussed below, we do not consider that Option 1 would amount to a disproportionate exercise of legislative power given that the TUSOP Agreement specifically contemplates the possibility of a scope change under the legislative framework during its term.

[23] Draft Recommendations 3.1and 9.1

[24] Draft Recommendation 5.1

[25] Information Request 9.1

With regard to payphones, we support the Commission's findings that there is a relatively strong case for immediately winding back Telstra's contractual obligations and the Australian Government should seek an early termination of the payphones component of the TUSOP Agreement[26].

VHA does not support the Commission's Option 2[27] as it would have the practical effect of delaying or preventing much-needed USO reform. The Productivity Commission itself recognises the concerns with Option 2 in the following terms:

> *A possible disadvantage of this option is that it would see the continuation of annual standard telephone service payments for the final years of the NBN infrastructure rollout - resulting in a further $1 billion of payments for the standard telephone service USO (or more, in the event that the NBN rollout takes longer than expected, and is not completed by 2020).*

VHA considers that Option 3[28] could be attractive, namely winding back the STS gradually as the NBN is deployed. This rollout progress could then be reflected in a gradual reduction of the payments to Telstra under the TUSOP Agreement. As noted in our submission to the Issues Paper, it seems incontrovertible that the current STS USO should be phased out as the NBN fixed wireless and satellite footprint is rolled out. NBN Co. will effectively deliver the bulk of the USO requirements through the deployment of infrastructure which not only delivers high speed broadband data services, but also can deliver reasonable voice services.

However, adopting Option 3 would require that all the criteria for clause 7.2 of the TUSOP Agreement be met in order to avoid a situation where the Government was held hostage to Telstra's commercial interests by reason of Telstra's effective ability to veto amendments to the TUSOP. There is little (if any) incentive for Telstra to renegotiate the TUSOP Agreement to achieve an outcome that is consistent with the public interest. Even if Telstra were to agree to renegotiate the scope of the STS USO, legislative change would still likely be required. As a consequence, Option 1 should be preferred.

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[26] Draft Recommendation 9.2

[27] Ibid

[28] Information Request 9.1

A new USO framework

The NBN has made substantial progress towards providing universal access to high-speed broadband services to all premises across Australia by 2020 and, as of 19 January 2017, over 3.9 million premises were ready for service by the NBN. The NBN is expected to provide peak wholesale download data rates (and proportionate upload rates) of at least 25 megabits per second to all premises, and at least 50 megabits per second to 90 percent of fixed line premises.[29]

Moreover, each of the fixed-line, wireless and long-term satellite technologies will be more than capable of providing reliable, high quality voice over internet protocol (**VoIP**) services. In particular, NBN Co. currently offers wholesale fixed-line and wireless download speeds of up to 1Gbps and 50Mbps respectively and has stated that its long-term satellite service will be capable of delivering wholesale download speeds of up to 25Mbps.[30]

In addition, the Government has recently introduced an exposure draft of a bill that would see NBN designated as a statutory infrastructure provider (**SIP**) and required to connect a premises and supply a service within the NBN footprint upon a reasonable request from a retail service provider (**RSP**).[31] If enacted, this will ensure that NBN services are available to any premises within the NBN footprint. The cost of NBN's wholesale services will also continue to be capped as a consequence of its special access undertaking which has been accepted by the ACCC under Part XIC of the of the *Competition and Consumer Act 2010 (Cth)* (**CCA**).

In this context, the Commission can be confident that any amendments to the TCPSS Act which confine the scope of the current STS USO to areas outside the NBN footprint will not endanger end-user access to quality services.

[29] SOE (24 August 2016)

[30] NBN, Products, services and pricing (24 January 2017) <http://www.nbnco.com.au/sell-nbn-services/products-services-pricing.html>; nbn, Sky MusterTM Service (24 January 2017) <http://www.nbnco.com.au/connect-home-or-business/information-for-home/satellite.html>; nbn, Fixed Wireless (24 January 2017)

[31] NBN Co. Special Access Undertaking (18 December 2012, varied on 18 November 2013).

The Standard Telephone Service USO

Amending the TCPSS Act

VHA considers amendments to the TCPSS Act to be most direct route for achieving a transition away from the current STS USO arrangements.

Part 2 of the TCPSS Act sets out the universal service regime, defines the scope of the STS USO and identifies who must receive these services in order for the obligation to be satisfied. Based on the Commission's Draft Report, VHA understands that the TUSOP Agreement itself provides for a renegotiation mechanism should any change to the legislative scope of the STS USO occur.[32]

VHA submits that the simplest and most effective method of transitioning away from the current STS USO arrangements would be to enact certain carve outs of Telstra's legislative STS USO. Specifically, sections 9(1)(a) and 9(2) of the TCPSS Act should be amended so that Telstra's STS USO will not apply to premises in areas where NBN's SIP obligations have been triggered.[33]

The current exposure draft of the legislation to implement the SIP regime contemplates that upon beginning to supply listed carriage services to an area, NBN must give written notices.[34] Once notice is given, NBN becomes the SIP in respect of all premises in that area and assumes the obligation to connect and supply a service upon a reasonable request from a retail service provider.[35] This mechanism provides a sound and clear basis or 'trigger' upon which Telstra's STS USO can be progressively wound back whilst ensuring that no premises are left without service.

[32] Box 9.1 (P 263), Module B, subclause 25.3

[33] Telecommunications Act 1997 (Cth), Part 19 as proposed by the Exposure Draft of the Telecommunications Legislation Amendment (Competition and Consumer) Bill 2017. The current definition of an STS in section 6 of the TCPSS Act is already sufficiently broad to enable the use of VoIP services to satisfy the STS USO such that no amendment is needed.

[34] Telecommunications Act 1997 (Cth), s 360D(2) as proposed by the Exposure Draft of the Telecommunications Legislation Amendment (Competition and Consumer) Bill 2017.

[35] Telecommunications Act 1997 (Cth), s 360E, as proposed by the Exposure Draft of the Telecommunications Legislation Amendment (Competition and Consumer) Bill 2017.

VHA recognises that, while the rollback of Telstra's STS USO would be largely self-executing, it would be prudent to have a robust monitoring process in place and to ensure timely and accurate information flows about the locations in which the SIP has been triggered.

To the extent that the Commission considers that it would be more appropriate to have a basic data service USO (rather than an STS USO), sections 6 and 9 could be amended to reflect that approach.

As regards the portion of the USO pertaining to payphones, VHA also notes Telstra's comments (via Jane van Beelen, Telstra's Executive Director for Regulatory Affairs) as reported in Communications Day on 1 February 2016 that a reduction in the scope of the payphones USO is contemplated under the terms of the TUSOP Agreement. Jane van Beelen was quoted as saying the following by Communications Day on behalf of Telstra in relation to the TUSOP Agreement:

> *We have a contract with the government… that was done in the context of the NBN… it was with TUSOPA, when that existed as a separate agency, but not it it's just with the Commonwealth. So that contract provides for – if the government wants to reduce the scope of the USO [and] the obligations we have to fulfil, to the extent that cost savings can be realised from reducing that scope – and provides the mechanism by which we can negotiate the obligation and reduce the funding.*
>
> *The most obvious way to do that is if they decide that they don't want us to have the payphones obligation anymore, there's a specific amount of money which is correlated under the agreement to the payphones obligation; if they remove that obligation… in a way that costs reduce by a certain percentage, then the finding that is dedicated to that would reduce by that percentage and the contributors would therefore presumably get that money back.*
>
> *That provision is there so whatever the government does with the scope of the obligation, the finding can follow. At the time, we probably thought it was equally likely that the government might seek to expand our obligation and that mechanism was designed to ensure that if they expanded the obligation, we'd get paid for it. But it does work both ways.*

As VHA understands the TUSOP Agreement (from Box 9.1of the Draft report), Jane van Beelen is referring to clause 7.2 of the agreement. Box 9.1 explains that the payment for the USO modules of the TUSOP Agreement can be adjusted in the event of a change of the scope of the USO. The scope of the USO is set by reference to the statutory obligation(s) imposed on Telstra in the TCPSS Act.

VHA cautions that the detail of the TUSOP Agreement will be important, including any thresholds set to trigger the reduction in payment under clause 7.2 and any exceptions for specific circumstances. Accordingly, it will be important that the Government's policy solution is wholly compliant with the requirements of this clause. However, VHA assumes that if Telstra is relieved absolutely of its payphone obligations under the TCPSS Act, then this would remove all requirements on the Government (and hence ultimately VHA by way of the USO levy) to pay USO funding to Telstra in relation to payphones under the TUSOP Agreement.

The Commission has identified in its Draft Report that the same solution that could be adopted for payphones (namely the use of clause 7.2 of the TUSOP) could equally be applied to the funding obligations in relation to the STS.

Ministerial determinations may be an alternative

Under the TCPSS Act the Minister is granted broad discretion to determine a range of matters associated with the USO. This may present an alternative to legislative reform if the timing of legislative change is of concern.

The relevant provisions of the TCPSS Act are:

- Section 8BA – which provides that the Minister can make a determination specifying certain characteristics of the STS the subject of the USO.
- Section 9B – which provides the Minister with the power to divide the STS USO and specify what must be supplied or done in order to fulfil that obligation.
- Sections 12A and 12C – which provides that the Minister can make a determination that a specified carrier or carriage service provider is the primary universal service provider (**PUSP**) and, as a result, must fulfil the USO.
- Sections 12EB and 12EC – which provide that the Minister can make standards and/or benchmarks in relation to the supply of a STS to a customer or prospective customer. These standards could be aimed at promoting transparency, particularly in relation to the services provided by Telstra, the relevant costs incurred and the payments it receives from the Secretary.

Ultimately, if the legislative reform option presents challenges, a similar rollback of Telstra's STS USO may be able to be achieved by the exercise of these discretions alone or in combination. For example, the Minister could potentially make a determination under section 9B that divides the STS USO into separate wholesale and retail components and use section 12A to designate NBN Co. as the wholesale universal service provider in areas within the NBN footprint. Telstra could remain the retail service provider and, where the NBN network is yet to rollout, the wholesale provider. Given the extent of the NBN rollout so far, this would substantially reduce the scope of Telstra's STS USO and the corresponding costs of maintaining infrastructure to meet that obligation.

Commensurate reductions in USO payments to Telstra

As the current STS USO is rolled back, there is no legitimate basis upon which the payments Telstra receives under the TUSOP Agreement should continue at current levels.

The operation of the SIP regime alone will transfer the majority of the cost associated with connecting difficult to serve premises from Telstra to NBN and, subject to the comments about the copper continuity obligation below, Telstra's costs should progressively reduce to zero as the NBN rollout completes in 2020.

While the lack of transparency of the TUSOP Agreement makes it difficult for VHA to provide the Commission with specific figures, it is self-evident that a narrower STS USO obligation will bring about a reduction in costs for Telstra. Telstra acknowledged this following the release of the Commission's Draft Report, noting that, if the Government changes the USO in the future and shifts that obligation to the NBN, it and other telecommunications service providers may no longer need to contribute to its funding.[36]

As a result, Telstra has little basis to object to a reduction in payments under the TUSOP Agreement following the narrowing of its STS USO obligation. There ought also to be a corresponding reduction in the Telecommunications Industry Levy, which would result in significant cost savings across the industry and would reduce the burden on consumers.

In this context, it is critical that the Government take a firm line in terms of any renegotiation of payments under the TUSOP Agreement and carefully scrutinise any claims Telstra makes regarding its costs of meeting the STS USO. This is essential to promoting the long-term interests of end-users given that service providers ultimately pass on at least a proportion of the STS USO cost onto their consumers.[37]

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[36] https://exchange.telstra.com.au/2016/12/07/positive-updates-to-australias-universal-service-obligation-content/

[37] As identified by the Commission: Productivity Commission, 'Telecommunications Universal Service Obligation: Draft Report' (November 2016), page 245.

The Copper Continuity Obligation (CCO)

While VHA considers Option 1 to be the most appropriate method for transitioning away from the current STS USO arrangements, there is a risk that this approach may not address the issues relating to Telstra's CCO.

As stated above, NBN is expected to provide peak wholesale download data rates (and proportionate upload rates) of at least 25 megabits per second to all premises, and at least 50 megabits per second to 90 percent of fixed line premises.[38] This, in conjunction with the proposed SIP regime, will ultimately ensure that everyone in Australia has access to broadband services that can adequately support high quality voice communications.

In this context, the CCO represents a grossly inefficient duplication of what is essentially natural monopoly infrastructure. This is highly allocatively inefficient and unlikely to promote the long-term interests of end-users given that telecommunications service providers will continue to recover their CCO cost contributions from consumers.

While maintaining the CCO clearly comes at significant cost, it is difficult for VHA to quantify the exact amount given the lack of transparency of Telstra's CCO arrangements. However, it is clear that without the removal of the CCO the benefits that are likely to flow from any winding back of Telstra's STS USO may be minimal because of the low marginal cost of offering the STS USO on top of the CCO. It is therefore critical that the CCO is removed as part of any contractual negotiations.

From the Commission's Draft Report it is unclear as to how the Commission proposes to deal with this issue. On the one hand the Commission recognises that the CCO is "integrated into [Telstra's] *contractual* obligation for providing the STS USO" – suggesting that the CCO sits outside of the legislative regime and would require separate renegotiation.[39] On the other hand, the Commission appears to suggest that the CCO "would only apply where the standard telephone service USO continued to apply" – implying that the CCO can simply be rolled back by amending the STS USO

[38] NBN Co Ltd, Statement of Expectations (24 August 2016).

[39] Productivity Commission, 'Telecommunications Universal Service Obligation: Draft Report' (November 2016), page 18

legislative arrangements.[40] VHA requests that the Commission clarify its position on this issue and explicitly recommend an approach that addresses it.

One option might be for the Commonwealth to insist upon a removal of the CCO as part of any variation negotiated under clause 25.3 of the TUSOP Agreement. VHA acknowledges that Telstra may need to be paid reasonable compensation if it has made long-term investment decisions in anticipation of the continuation of the CCO. However, it is absolutely critical that a rigorous approach to determining this quantum be adopted.

Given the ongoing expense that Telstra faces in maintaining copper infrastructure that could otherwise be refined and/or redeployed, there can be no reasonable basis for it to refuse to negotiate a cessation of this obligation and a commensurate reduction in payments under the TUSOP Agreement.

Dealing with contractual and regulatory complexities

VHA appreciates the contractual and regulatory complexities involved in any proposed changes to the scope of the STS USO. However we do not consider that the legislative changes above would create a material risk for future contractual arrangements between Government and the private sector. The TUSOP Agreement itself contemplates this very scenario in clauses 7.2 and 25.3. As a highly sophisticated operator, this should come as no surprise to Telstra.

In response to any argument that the Government exercising its legislative (or executive, in the event it goes down the Ministerial Determination path) rights is disproportionate, it need only point to the inexorable shift towards wireless and digital telecommunications technologies (including Telstra's own investments in this area).[41] These changing preferences as well as the success and speed of the NBN rollout already render the STS USO and much of the TUSOP Agreement redundant, let alone as it moves closer towards the expiration of its 20 year term.

The TUSOP Agreement contemplates change

As noted above, the TUSOP Agreement explicitly provides scope for adjustments to payment amounts following a change in the scope of the USO. This indicates that the parties anticipated that the scope of

[40] Productivity Commission, 'Telecommunications Universal Service Obligation: Draft Report' (November 2016), page 272.

[41] Communications Day, 'Gigabit LTE arrives in east coast capitals' (1 February 2017).

the Agreement may require renegotiating, due to a change in consumer preferences and/or technological or industry developments.

Clause 7.2 of the TUSOP Agreement specifically provides that payment of the TUSO modules can be adjusted in the event of a change in the scope of the TUSO, which is to be set by reference to the obligations in the TCPSS Act. Further, subclause 25.3 under Module B provides that the parties to the TUSOP Agreement can agree to a variation in the *event of a scope change to the relevant legislation*. It follows that a change to the legislation under subclause 25 should trigger a renegotiation of the TUSOP Agreement's payment amounts under clause 7.2.

Therefore, if the Government does amend the TCPSS Act and utilise its rights under clause 7.2 in the manner proposed, this is clearly an avenue available to the Government that was within the full contemplation of Telstra at the time that it negotiated and executed the TUSOP Agreement.

Risk for future contractual arrangements between Government and the private sector

The Commission's Draft Report identified that the Government may view this option with caution, due to a perceived risk that it would set an undesirable precedent for future contractual arrangements between the Government and the private sector.

VHA submits that the risk is overstated because, if a rigorous policy-based approach is adopted when making the requisite changes, all stakeholders should experience cost savings.

Telstra cannot object to proposed changes to the TCPSS Act

It is possible that Telstra may oppose the implementation of Option 1 (although it is hard to see why unless the TUSOP Agreement is overcompensating it for the costs of meeting the STS USO and CCO). To the extent it does, the High Court's decision in *Telstra Corporation Limited v The Commonwealth*[42] would likely prevent any constitutional challenge by Telstra to the new legislation on the basis of an acquisition of property other than on just terms.

[42] [2008] HCA 7.