



Response to submissions on wholesale ADSL pricing

A REPORT PREPARED FOR KING & WOOD MALLESONS

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1 Introduction and summary

In February 2012, the Australian Competition and Consumer Commission (ACCC) declared wholesale ADSL services under Part XIC of the Competition and Consumer Act 2010. The ACCC is currently consulting on the terms of a final access determination (FAD) in respect of wholesale ADSL services.

Frontier Economics¹ was engaged by lawyers for Telstra to prepare an expert report on two topics to assist the ACCC in making its FAD:

- the management of congestion in electricity networks
- the potential advantages of using a ‘retail minus’ access pricing approach for declared wholesale ADSL services.

This report is available on the ACCC’s website.²

The ACCC has received a number of submissions on both Telstra’s submissions and on the Frontier Economics report. Optus, in particular, has some specific criticisms of the Frontier report:

- That Frontier was instructed to assume that the market in which wholesale ADSL services were supplied was competitive, and did not reach its own conclusion that the market was competitive (paragraph 2.38) and
- That our advice was inconsistent with two other reports prepared by Frontier Economics on (a) costing methodologies for NGA access and (b) access pricing approaches for backhaul transmission networks.

The purpose of this short reply report is to respond to some of the specific criticisms of our earlier work. In particular, we consider that:

- On the basis of the information supplied to us, and on our knowledge accumulated during the course of previous analyses of competition in related wholesale services, that competition in CBD and metropolitan markets in which Telstra supplies wholesale ADSL services is likely to be strong or vigorous.
- There is no inconsistency in our advice provided in Europe or Australia on the appropriate role for retail-minus access pricing approaches. Frontier’s advice in other contexts can be readily reconciled with the use of retail minus in the context of wholesale ADSL.

¹ The report was prepared by two employees of Frontier Economics, Stephen Farago and Rajat Sood.

² Frontier Economics, ADSL network congestion pricing and use of RMRC, August 2012, available at <http://www.accc.gov.au/content/index.phtml/itemId/1076260>.

2 Wholesale ADSL competition in some geographic areas is strong

In preparing our initial report, we received instructions from King & Wood Mallesons, acting for Telstra. These instructions stated:

For the purpose of responding to the questions in section 2.1 above, please assume that the state of competition in the wholesale ADSL market...are as described in section 1.3...and the attached documentation.

Section 1.3 of these instructions further state:

In Telstra's response to the FAD First Discussion Paper, it provided evidence to support its contention that, in central business district and metropolitan areas, there is significant competition in respect of the market for wholesale ADSL services.

In our first report, we then stated that:

In these metropolitan markets, Telstra faces strong competition from a range of ISPs using Telstra's ULLS and LSS services and their own DSLAM and transmission services, as well as competition from the Optus HFC.

It is evident from these statements that the instructions from King & Wood Mallesons did not place a constraint on our assessment of competition in broadband markets. Rather, we were provided with information to support a contention that there is significant competition in the market. This information was referenced in our conclusion that Telstra faces strong competition in central business district (CBD) and metropolitan markets.

We understand that the reference to "market" here is a reference to the product markets in which wholesale and retail ADSL services are supplied, which includes both direct constraints from other suppliers of wholesale ADSL services (including self supply of those services using ULLS and LSS inputs) and other similar broadband services (e.g. services provided over Optus's HFC network or using direct fibre). This is consistent with the ACCC's product market definitions described in its Final Decision to declare the wholesale ADSL service.³ The instructions also refer to specific geographical markets (CBD and metropolitan markets), which are not the same as proposed by the ACCC in its Final Decision, but are the subject of consideration in the FAD – as discussed on page 11 of the July 2012 discussion paper.

The key test of competition in a market is whether Telstra is constrained to a material degree by the services available from competitors, or from potential new

³ ACCC, *Final Decision: Declaration of the wholesale ADSL service under Part XIC of the Competition and Consumer Act 2010*, February 2012, pp. 10-13.

competitors.⁴ To avoid any doubt, we do consider that there are some compelling reasons to believe that in particular geographic areas, Telstra is effectively constrained in its supply of wholesale ADSL services by:

- the availability of substitutes in the form of other wholesale inputs (and in particular ULLS, LSS and other infrastructure competitors); and by
- the availability of indirect retail substitutes (the supply of retail broadband services by competitors with access to other wholesale inputs or their own infrastructure).

The relevant geographic areas in which competition is strong or significant relates to the 289 ESAs in which Telstra faces at least three major competing DSLAM-based providers of wholesale and retail ADSL services and its market share is less than [c-i-c] of retail lines and Telstra's wholesale ADSL share of total ADSL broadband is less than [c-i-c]. We further understand that Telstra has experienced a significant loss of wholesale and retail market share within these ESAs over the past four years.

In these ESAs, it does appear that the structural conditions which appeared to favour more competition (e.g. the availability of wholesale inputs to reduce barriers to entry, and entry by a number of competitors) have in fact resulted in an increase in actual competitive pressure on Telstra, reflected in its losses of retail and wholesale market share.

Further, this conclusion is not likely to be changed by consideration of pair-gain systems within those ESAs, which may effectively give Telstra a monopoly over the supply of wholesale ADSL services over those lines. This is because we understand Telstra does not price discriminate at the retail or wholesale level between those customers on pair gain systems and those that are not, meaning that there is no ability to 'cross subsidise' (by charging higher prices to those on

⁴ As discussed, for example, in *Application by Chime Communications Pty Ltd (No 2) [2009] ACompT 2* (27 May 2009)

[22] "In light of the foregoing it is the Tribunal's view that to determine the degree of competition that exists in a market it is necessary to examine both the state of actual rivalry between firms that are in the market and the threats to incumbent firms from new suppliers."

And:

[48] "In the Tribunal's view a market is sufficiently competitive if the market experiences at least a reasonable degree of rivalry between firms each of which suffers some constraint in their use of market power from competitors (actual and potential) and from customers. The criteria for such competition are structural (a sufficient number of sellers, few inhibitions on entry and expansion), conduct-based (eg no collusion between firms, no exclusionary or predatory tactics) and performance-based (eg firms should be efficient, prices should reflect costs and be responsive to changing market forces)"

pair gain systems) and that both sets of retail customers enjoy the benefits of competition between service providers within those ESAs.⁵

This is not to suggest that our conclusion is that all areas in which wholesale ADSL services are supplied were competitive. Rather, it is an indication that there are certain geographic areas in which competitive constraints are likely to prevent Telstra from raising retail and wholesale ADSL prices to excessive levels. This in turn has implications for the choice of a suitable access pricing methodology.

For completeness, we also note that our conclusions here are consistent with conclusions we have previously drawn on the competitiveness of wholesale line rental (WLR) and local carriage service (LCS) services. In this earlier work, we found that competition in the supply of WLR and LCS services was not likely to be effective even within ESAs where there had been multiple entrants using Telstra's ULLS and LSS services. We found that this could occur where end users were only interested in acquiring a standard voice service, and not bundles of voice and broadband services. We further noted that competition for bundles of voice and broadband services was much stronger than for voice-only services:⁶

"In summary, competition for customers that only wish to buy fixed voice services (and perhaps wish to buy data services separately) appears to be quite different than for those customers that are willing to buy a bundle of voice and data services" (p. 9)

Competition in markets for bundled voice and broadband services is more vigorous" (p. 10)

This conclusion is also consistent with the ACCC's expressed views in its second discussion paper (July 2012, p. 13).

⁵ Telstra, *Response to the Commission's Issues Paper (a second discussion paper) into the public inquiry to make a final access determination for the wholesale ADSL service: Pricing to Improve Customer Experience*, Public version 24 August 2012, pp. 20-21.

⁶ Frontier Economics, *Geographic exemptions for WLR, LCS and PSTN OA services: A Report Prepared For Macquarie Telecom*, June 2011, available at: <http://www.accc.gov.au/content/item.phtml?itemId=991582&nodeId=68bf7732b4d1f0f3ddc3ecf62deb3c67&fn=Public%20submission%20by%20Frontier%20Economics%20on%20behalf%20of%20Macquarie%20Telecom.pdf>

3 The use of RMRC as an access pricing methodology is sound in certain circumstances

At 2.39 of its submission, Optus states that “outside of the restrictive terms of engagement, ...retail minus is not supported by regulatory best practice or by Frontier Economics.”

There are two issues with this statement by Optus:

- The first issue is that these criticisms are not pertinent to whether Telstra’s current retail prices are likely to be efficient, and (in what is much the same inquiry) whether the ‘market’ in which wholesale is ADSL supplied is competitive.
- The second issue is that Optus does not recognise that Frontier Economics has previously acknowledged that retail minus methodologies can be an appropriate means to set access prices under certain circumstances. An example of these kinds of circumstances is relevant to the current case – that there are no monopoly rents being earned in the supply of wholesale ADSL services in CBD and metropolitan markets.

3.1 Competition should deliver efficient prices

In section 2 of this report, we re-iterated our view that competition in certain geographic areas for the supply of wholesale and retail fixed line broadband services was likely to be strong or vigorous. It follows that retail prices in these geographic areas can be expected to be efficient, in the sense of:

- not embodying any monopoly rents (prices in excess of underlying costs) that can be sustained over time; and
- responsive to changes in underlying costs over time, including appropriately accounting for (‘internalising’) the external costs of congestion that users impose on each other.

Consequently, Optus’s criticism that we assumed away the central downside of retail minus approaches is inaccurate – rather, this follows from an examination of the relevant market context.

3.2 Other Frontier Economics papers do not invalidate the use of retail minus

Optus refers to two papers in which Frontier Economics is cited as not supporting the use of retail minus access pricing methods:

- a Frontier Europe (an affiliate of Frontier Australia) submission on costing methodologies for NGN access⁷ (paras 2.37, 2.39-2.40, 2.48, 2.54-2.56 of the Optus submission)
- a paper by Frontier Australia prepared for the ACCC on transmission pricing (para 2.50).

There is, however, no inconsistency between these advices and the expert report submitted to the ACCC in this case.

3.2.1 Advice to Vodafone

The advice provided to Vodafone in Europe was provided within the confines of a narrow remit – to determine appropriate ‘cost-based’ methodologies for NGN access services. It is clear from parts of the report that the report *presumes* that it is appropriate to apply a costing approach to the underlying network assets (for example, on page 8 of the report it is noted that “A wide range of potential methodologies have been used and developed for determining the annual costs of assets in a regulatory context.”)⁸ This presumption reflects that competitive constraints on NGA suppliers in Europe are expected to be weak. As noted in section 2, this is not the situation currently faced by Telstra in its supply of wholesale and retail ADSL services; at least in not in certain CBD and metropolitan markets and, as Telstra adopts uniform national pricing for wholesale ADSL, by extension to other markets outside these CBD and metropolitan areas where Telstra might face fewer direct competitors.

Further, at section 3.5 of the report, Frontier specifically notes that if there are significant externalities, setting regulated prices on the basis of forward looking costs alone could lead to welfare enhancing investment not being undertaken. This is because for prices to be efficient, they need to account for both the private costs of use as well as the social costs and benefits of use. Although the example given relates to pricing below cost to capture positive externalities from greater use of broadband, in cases of congestion this argument can readily be extended to suggest that prices might need to be above the private costs of usage to reflect the costs imposed on other users.

There are also other aspects of the Frontier report which are relevant but have not been addressed by Optus. For example, in 2.55 of its submission, Optus suggests that historic cost accounting approaches should be used in line with Frontier Economics’ advice and in line with the approach used in the ACCC’s fixed line services model (FLSM). However, Optus only refers to the Frontier recommendations on the costing of ducts, and not the recommendations for

⁷ Frontier Economics, *Access Network Costing: A report for Vodafone*, June 2011.

⁸ In contrast, a retail minus approach removes the need to consider the valuation of the underlying network assets – as these are not used in the calculation of the access price.

costing of other assets. Aside from investments in ducts and other ‘passive’ assets like copper, an access provider must also invest in ‘active’ assets to supply wholesale ADSL services, such as DSLAMs and MSANs. For these kinds of assets, Frontier recommended that these should be valued using current cost accounting approaches, reflecting that these assets are replicable and should be valued at their replacement cost to provide better build/buy signals for competitors and the incumbent. In other words, a different costing approach was recommended taking into account the specific nature of the investments and likely competitive situation in the future. This is consistent with Frontier’s approach to wholesale ADSL pricing, which recognises that different competitive (or other) conditions can justify a different access pricing approach.

We finally note that if a current or replacement cost method for valuing assets used to supply wholesale ADSL was adopted by the ACCC, it would in fact require changes to the costing approach in the ACCC’s FLSM.

3.2.2 Advice to the ACCC

Frontier Australia’s paper prepared for the ACCC on regulated backhaul transmission pricing did give consideration to a wide range of access pricing approaches.

In its commentary on retail minus pricing approaches, we presented a range of material on the circumstances in which retail minus (and its close relation, the ECPR) could be an appropriate approach:

“...when used in certain contexts, the logic of the ECPR is compelling.”⁹

“the ECPR sets access prices by focusing only on activities in the downstream...market...In doing so, it preserves any profits (or losses) that derive from the upstream market.”¹⁰

“The primary usefulness of the ECPR occurs when one is not so concerned about the price level but rather ensuring efficient entry...”¹¹

It is quite clear from these statements that the treatment of the margin between the wholesale price and cost is critically important to the favouring of this kind of pricing approach. If the margin between wholesale prices and costs is considered reasonable, then the major problem associated with the use of retail minus for access pricing is obviated.¹² In this case, the question is whether Telstra can sustain unreasonable margins between the cost of inputs such as ULLS or LSS

⁹ Frontier Economics, *Economics of Transmission Capacity Service: A report prepared for the ACCC*, June 2009, p. 47

¹⁰ *ibid.* p. 47

¹¹ *ibid.*, p. 48

¹² There may be practical issues associated with the implementation of a retail minus approach, as we observed in our initial report on page 12.

and wholesale ADSL services. If it can not due to competitive pressure from other suppliers of retail ADSL and other broadband services, then the use of retail minus offers a potentially less complex and more efficient way (taking into account management of congestion externalities) of setting an access price for wholesale ADSL services.

We also note that there are other aspects of this report that are pertinent to this process. In its considerations of efficient pricing structures for backhaul transmission services, Frontier suggested “In theory, some form of congestion pricing may be appropriate to ration scarce capacity”, although it ultimately was thought not to be a material factor in backhaul transmission pricing at that time.¹³

¹³ *op.cit.*, p. 24

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