

Telecommunications competitive safeguards for 2003–04

Report to the Minister for Communications, Information Technology and the Arts

March 2005



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3rd March 2005

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Dear Minister

The Australian Competition and Consumer Commission (the ACCC) is required under the *Trade Practices Act 1974* (the Act) to annually review and report on:

- competitive safeguards within the Australian telecommunications industry (subsection 151CL(1) of the Act)
- changes in prices paid by consumers for telecommunications services (subsection 151CM(1)(a) of the Act).

Enclosed are the two reports for financial year 2003–04. As you are aware, subsections 151CL(5) and 151CM(3) of the Act require that within 15 sitting days of receipt of these reports you table them in each House of Parliament.

I have highlighted the key messages in each report below.

Report 1—Telecommunications competitive safeguards

Over the past seven years open competition in telecommunications has provided positive consumer outcomes typically characterised by large price reductions. In 2003–04, however, the positive effects of the access based regulatory regime slowed, continuing a trend observed in the 2002–03 period.

The initial benefits of the current regulatory regime were delivered as competitors entered at the retail level, made use of regulated interconnection rates and drove down retail costs. Generally, however, competition on this basis has only allowed new entrants to build limited market share and the industry remains concentrated.

Given this, further market advances, in terms of higher quality and more keenly priced services, will only be likely if there is an increase in competition further up the value chain; in facilities or quasi facilities-based markets.

EXECUTIVE OFFICE



Further, without this development it is difficult to say that the competition currently in the market is 'sustainable'. One of the policy goals of economic regulation is the removal of regulation if adequate competition can be sustained. Most current competitors, however, rely on the heavily regulated supply of wholesale products. The premature removal of regulation would therefore be likely to lead to a substantial lessening of competition and the loss of many of the benefits that have already been achieved.

That said the access-based regime remains an essential input into a competitive telecommunications market. The ACCC, for example, considers that the access-based long-distance and international call markets show encouraging signs of growing competition and are delivering real consumer benefit.

Encouraging the move to facilities-based competition, and enabling more light-handed regulation, requires overcoming difficulties which are posed by Telstra's dominance in the customer access network and fixed-line market. Telstra owns and operates the copper local loop, an essential input into a broad range of telecommunications products and the only ubiquitous customer access network. This historical fact means that Telstra enjoys many natural advantages and has the ability and incentive to distort the growth of sustainable, facilities-based, competition. The ACCC will therefore be placing considerable emphasis on ensuring that competitors have equal access to Telstra's underlying, regulated facilities.

2003–04 has also seen increased interest in the impact of new technologies, most notably voice-over internet protocol (VoIP), wireless local loop and, to a lesser extent, fibre to the home. VoIP and wireless networks have been seen by some as technologies that will break the dominance of the incumbent fixed-line network and lead to more sustainable competition. However, the impact of these technologies has, to this point, only been felt in the corporate and some other small niche markets.

The ACCC takes the view that, while there is potential for greater competition in these new services, their impact has not yet been demonstrated. In such a setting it is premature to suggest that there is a reduction in the need for oversight of competition.

In terms of the ACCC's work in the 2003–04 financial year, the report provides a detailed overview of the activities undertaken by the ACCC in fulfilling its regulatory functions.

Report 2—Changes in prices paid for telecommunications services in Australia

The ACCC assesses that the overall average price paid by consumers for telecommunications services fell in real terms by 1.1 per cent during the 2003–04 financial year. This overall decline was the result of a fall of 3.2 per cent in prices paid for mobile telephony services on one hand, and a marginal increase of 0.2 per cent in prices paid for PSTN services on the other.

The average price paid for PSTN services rose slightly due to residential and small business consumers experiencing price rises of 1.4 per cent and 3.1 per cent respectively. This was offset by consumers in the 'other business' category experiencing a price fall of 5.6 per cent. ACCC analysis indicates that prices paid by both residential and small business consumers and 'other business' consumers are

now moving in different directions. In recent years, average prices paid by residential and small business consumers for PSTN services have been going up, while prices paid by large business consumers have been falling.

In terms of prices paid for individual PSTN services, the rebalancing trend observed in previous years continued in 2003–04, with the average price paid for basic PSTN access rising by 6.8 per cent.¹ However, unlike in previous years, the price rise in basic access for residential and small business consumers was not offset by falls in the prices of per-call services. In fact, average prices paid by these two consumer groups for fixed-to-mobile and national long-distance calls rose during the year. For 'other business' consumers, the price increase in basic access was more than offset by price falls in per-call services.

With regard to the overall price paid by consumers for mobile telephony services, the 3.2 per cent price decrease was primarily due to lower prices paid by consumers for pre-paid services on both the GSM and CDMA networks, which fell by 5.6 per cent and 4.3 per cent respectively. Prices of post-paid services, on the other hand, fell by just 1 per cent for GSM services and 1.5 per cent for CDMA services.

The ACCC observes that in 2003–04 nearly half of all mobile services in operation were pre-paid services. This represents substantial growth in pre-paid services over the last five years. The larger price falls for pre-paid services suggest that carriers are competing more intensely in this market segment.

Overall, GSM mobile telephony consumers enjoyed slightly larger price falls at 3.2 per cent, compared to CDMA users for whom prices fell on average by 2.2 per cent.

Yours sincerely



Graeme Samuel
Chairman

¹ The ACCC considers that the result for the average price paid for basic access service should be treated with caution as the increase in the average price paid by residential customers is likely to have been underestimated. This is further explained in section 5.2 of the report.

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1 Summary

Under Part XIB, Division 11, subsection 151CL(1) of the *Trade Practices Act 1974*, the Australian Competition and Consumer Commission (ACCC) is required to provide the Minister for Communications, Information Technology and the Arts with an annual report on competitive safeguards within the Australian telecommunications industry.

This report covers financial year 2003–04 and ongoing actions immediately afterwards. All of the ACCC publications referred to in this report are available at www.accc.gov.au.

The key findings of the report are outlined below.

1.1 State of competition

Over the past seven years open competition in telecommunications has provided positive consumer outcomes typically characterised by large price reductions. In 2003–04, however, the positive effects of the access-based regulatory regime slowed, continuing a trend observed in the 2002–03 period. The initial benefits of the current regulatory regime were delivered as competitors entered at the retail level, made use of regulated interconnection rates and drove down retail costs. Generally, however, competition on this basis has only allowed new entrants to build limited market share and the industry remains concentrated.

Further market advances in terms of higher quality and more keenly priced services will only be likely if there is an increase in competition further up the value chain in facilities or quasi facilities-based markets. Without this development it is difficult to say that the competition currently in the market is ‘sustainable’. One of the policy goals of economic regulation is the removal of regulation if adequate competition can be sustained. Most current competitors, however, rely on the heavily regulated supply of wholesale products. The premature removal of regulation would therefore be likely to lead to a substantial lessening of competition and the loss of many of the benefits that have already been achieved.

That said the access-based regime remains an essential input into a competitive telecommunications market. The ACCC, for example, considers that the access-based long-distance and international call markets show encouraging signs of growing competition and are delivering real consumer benefit.

Encouraging the move to facilities-based competition and enabling more light-handed regulation requires overcoming difficulties which are posed by Telstra’s dominance in the customer access network and fixed-line market. Telstra owns and operates the copper local loop, an essential input into a broad range of telecommunications products and the only ubiquitous customer access network. This historical fact means that Telstra enjoys many natural advantages and has the ability and incentive to distort the growth of sustainable, facilities-based competition. The ACCC will therefore place considerable emphasis on ensuring that competitors have equal access to Telstra’s underlying, regulated facilities.

In 2003–04 there has also been increased interest in the impact of new technologies, most notably voice-over internet protocol (VoIP), wireless local loop and, to a lesser extent, fibre to the home (FTTH). VoIP and wireless networks are seen by some as technologies that will break the dominance of the incumbent fixed-line network and lead to more sustainable competition. The greatest potential of a technology like wireless local loop is that it is 'scalable', meaning that there is room for more than one provider in a given area without costly duplication of capacity. However, the impact of these technologies has, to this point, only been felt in the corporate and some other small niche markets.

The ACCC takes the view that, while there is potential for greater competition in these new services, their impact has not yet been demonstrated. In such a setting it is premature to suggest that there is less need for oversight of competition.

Overall the ACCC sees potential for greater consumer benefit. This will be achieved through the reduction in current access prices, particularly for the public switched telephone network (PSTN) and mobile termination, and strategies aimed at encouraging greater facilities-based competition.

1.2 Anti-competitive conduct and consumer safeguards

In 2003–04 the ACCC conducted nine anti-competitive telecommunications investigations, four of which were concluded within the financial year.

A Part A competition notice was issued to Telstra in relation to the wholesale and retail pricing of its broadband internet services.

The ACCC considered two third line force notifications.

There were substantive investigations into six telecommunications consumer issues involving the following companies:

- Optus
- Telstra
- National Telecoms Group
- Global Telecoms Group
- Global Pre Paid Communications and Global Networks

1.3 Tariff filing, record keeping, monitoring and reporting

Telstra complied with requirements to give the ACCC tariff filing information.

Final record keeping rules were issued to enable the ACCC to meet its obligation to provide enhanced accounting separation reports for Telstra. Record keeping rules were also issued to assess the effects of internet interconnection arrangements on competition.

The ACCC released two market indicator reports based on information collected through its regulatory accounting framework (RAF) record keeping rules.

The first report on competition in the corporate segment of the business customer group was submitted to the minister. The ACCC also continued to produce quarterly statistics on the take-up of broadband services.

1.4 Access-related activities

The ACCC concluded declaration inquiries into the following services:

- mobile terminating access service
- mobile originating access service
- mobile domestic inter-carrier roaming
- transmission capacity service
- internet interconnection.

It also continued an inquiry into mobile international inter-carrier roaming.

During the year the ACCC granted an anticipatory exemption in relation to the proposed supply of digital pay TV services by Telstra and Foxtel. The Australian Competition Tribunal subsequently upheld an application to set aside this decision.

The ACCC accepted revised analogue pay TV access undertakings from Telstra Multimedia (TMM) and Foxtel. The long-standing access disputes between TMM and Foxtel and TARBS and C7 were subsequently resolved with the withdrawal of the dispute notifications.

The ACCC rejected an access undertaking from Telstra in relation to the line sharing service (LSS). The ACCC accepted Telstra undertakings for the PSTN originating and terminating service and the local carriage service. Following the ACCC draft decision to reject the Telstra undertaking for the unbundled local loop service (ULLS), the ULLS undertaking was withdrawn by Telstra.

Model terms and conditions relating to access to the core telecommunications services were published.

Pricing principles were issued for the following services:

- mobile terminating access service
- transmission capacity service
- non-geographic number portability.

1.5 Activities under the Telecommunications Act

The ACCC commenced its review of the price control arrangements that should apply to Telstra following the expiry of the current arrangements on 30 June 2005.

The ACCC participated as an observer in several committees and the Next Generation Networks Framework Operations Group of the Australian Communications Industry Forum (ACIF).

2 Overview of the state of competition in telecommunications markets

2.1 Overview

Competition in telecommunications encourages new and innovative services, lower prices and, when the competition is sustainable, reduced regulatory oversight. This would, in turn, enable Australian business to produce better products at lower costs and compete more effectively in international markets. It would also provide Australian consumers with a range of lower priced and higher quality telecommunications products along with the benefits of decreased production costs and retail prices in other industries; and give Australian taxpayers the benefit of lower costs of ongoing regulation. A competitive telecommunications industry is therefore in the interests of all Australians and the ACCC's efforts in economic and competition regulation of this industry is directed towards these ends.

The introduction of open competition in telecommunications continues to provide positive outcomes for the Australian market. Prices have fallen significantly since the reforms were introduced in 1997 and new competitors continue to enter the market successfully. The recent market growth of Hutchison, for example, shows that it is possible to make a strong competitive impact as an infrastructure-based competitor.¹ That said, Australian telecommunications prices remain high in relation to the other OECD countries. In August 2004 Australian businesses' prices were the fifth highest in the OECD and residential prices the second highest.² Given the current reliance on access-based competition, these results may either indicate that access prices are too high or that there is insufficient competition at the retail level.

However, as noted in the ACCC's 2002–03 competitive safeguard report, there are signs that the positive effects of the regulatory regime are abating. The ACA, in its most recent *Telecommunications performance report*, notes that the benefits of the 1997 regulatory reforms are starting to slow.³ Further, the ACCC's accompanying *Changes in the prices paid for telecommunications services in Australia 1997–98 to 2003–04* (2003–04 price changes report) shows significant slowing in retail price falls and, in some cases, prices rises. This continues a trend observed in the previous 2002–03 period. These price rises are most evident in residential markets and are mainly driven by an increase in line rental charges.

1 The same period has also seen the failure of some potential infrastructure competitors such as Comindico. Therefore, while Hutchison's growth suggests that there is potential for sustainable infrastructure-based competition, it is clear that there are many difficulties for new operators entering the market.

2 OECD, *Economics surveys: Australia*, December 2004, p. 112.

3 ACA, *Telecommunications performance report 2003–2004*, December 2004, p. 31.

The initial benefits of the current regulatory regime were delivered as competitors entered at the retail level, made use of regulated interconnection rates and drove down retail costs. Generally, however, competition on this basis has allowed new entrants to build only a limited market presence and the industry remains concentrated.⁴ While this high level of concentration is partially a legacy of Telstra's former monopoly, with the first round of competitive benefits reaching a plateau, further market advances will be more likely if there is an increase in competition further up the value chain in facilities or quasi facilities-based markets.⁵ Without this development it is difficult to say that the competition currently seen in the market is 'sustainable'. Most competitors rely on the heavily regulated supply of wholesale products. The premature removal of regulation in this area would likely lead to a substantial lessening of competition and the loss of many of the benefits that have already been achieved. Facilities-based competition also creates significant room for market innovation that is not evident under an access and particularly a wholesale-based model.⁶ Such innovation provides the potential for competition characterised by greater product differentiation, higher consumer benefit and a more even spread of market share.

The access-based regime remains, however, an essential input into a competitive telecommunications market. The ACCC, for example, considers that the access-based long-distance and international call markets show encouraging signs of growing competition and are delivering real consumer benefit. This outcome does, however, not reduce the importance of a move to a more sustainable facilities-based model with the benefits of greater competition across more aspects of the price-product-service package. This observation is relevant across all telecommunications markets. While the access pricing regime continues to provide positive outcomes, more sustainable competition, leading to the removal of regulation, requires a greater degree of facilities-based competition. Providing a positive environment for this change is an ongoing aim for the ACCC.

Implementing this outcome, however, requires overcoming difficulties which are posed by Telstra's dominance in the customer access network (CAN) and fixed-line market. Telstra owns and operates the copper local loop, an essential input into a broad range of telecommunications products and the only ubiquitous customer access network. This historical fact means that Telstra enjoys many natural advantages and has the ability and incentive to distort the growth of sustainable, facilities-based competition to raise its own profits. This advantage is considerable—it is clearly a daunting task for competitors to wrestle market share away from a well-entrenched incumbent while at the same time purchasing most inputs from that same incumbent.

In 2003–04 there has also been increased interest in the impact of new technologies, most notably voice-over internet protocol (VoIP), wireless local loop and, to lesser extent, fibre to the home (FTTH). VoIP and wireless networks are seen by some as technologies that will break the dominance of the current fixed-line network and lead to more sustainable competition.⁷ The greatest potential of a

4 Comparison of market shares of new entrants across the OECD shows that in 2001 Australia was 8th in terms of access lines, 12th in terms of national long distance and 9th in international long distance. Further, in terms of access and national long distance, Australia lags well behind the leaders. See, OECD, *Economics surveys: Australia*, December 2004, p. 111.

5 The difference between facilities-based competition and other competition is outlined in footnote 6.

6 Access or service-based competition is when service providers rely heavily on the access and wholesale services of an incumbent to compete in retail markets. By contrast, facilities-based competition involves service providers using their own network infrastructure, often complemented by the use of lower level access services.

7 See, for example, the discussion of VoIP on the *7.30 report* in August 2004. Tim Lester, 'Telcos ready to bring on the revolution', 2 August 2004, available at www.abc.net.au/7.30/content/2004/s1167381.htm.

technology like wireless local loop is that it is 'scalable' meaning that there is room for more than one provider in a given area without costly duplication of capacity. However, the impact of these technologies has, to this point, only been felt in the corporate and some other small niche markets. It is also clear that there is potential for Telstra to frustrate the take-up of new technologies through the pricing of its legacy services, both at a wholesale and retail level.⁸

The ACCC takes the view that, while there is potential for greater competition in these new services, their impact has not yet been demonstrated. In such a setting it is premature to suggest that there is a reduced need for oversight of competition. FTTH, in particular, promises much but it is unlikely to become commercially viable in most parts of Australia for a considerable time and, without structural reforms, the growth of FTTH, when it does arise, is likely to perpetuate existing access concerns.

These views are perhaps more pessimistic than those held by some analysts which suggest that potential for substitution toward other competitive options, such as mobiles and new technology, may challenge Telstra's dominance. That view, however, is based on an optimistic view of the market over the long term and, in particular, the role played by substitution toward mobile, VoIP and wireless services. The ACCC, by contrast, believes there are still significant threats to the development of competition across all telecommunications markets and that, while future developments may remedy this, it would be naive to consider such developments inevitable in the absence of appropriate regulatory scrutiny. In particular, many of the more optimistic market analyses tend to discount Telstra's ability to respond to a loss in market share through leveraging, cross-subsidisation and various forms of discrimination in the access and retail market.

2.2 Measures of competition

2.2.1 Effective competition

While economic theory stresses the importance of perfect competition in providing efficient outcomes, a standard of 'effective competition' is more often applied in practice. The use of this lower standard is an implicit acceptance that the strict requirements for perfect competition are rarely met in practice and that the vast majority of benefits can be obtained at a lower level of competition.⁹ As Janusz Ordovery points out in his submission on this topic to the Productivity Commission:

... if one were to utilize perfect competition as the metric for determining whether effective competition exists, virtually all real world markets would not be effectively competitive ... Furthermore, in the telecommunications industry, acceptance of this view would apparently warrant perpetual regulation of the sector ...¹⁰

8 Lower wholesale pricing makes it less attractive to build new infrastructure, while lower retail prices make it harder to justify building. Finally, a reduction in the gap between wholesale and retail prices makes it difficult to build market share and may increase the risks inherent in a facilities-based strategy.

9 For a comprehensive discussion of the requirements for perfect competition see George Stigler, 'Perfect competition, historically contemplated', *Journal of Political Economy*, 65(1), 1957, pp. 1–17.

10 Janusz Ordovery, *Effective telecommunications service competition in Australia and the need for regulatory reform*, 26 November 2000, available at www.pc.gov.au/inquiry/telecommunications/subs/sub043.pdf, p. 8 and p. 40.

The ACCC concurs that perfect competition is not attainable and that perpetual regulation is not in the interests of the market. The ACCC therefore accepts that a standard of effective competition is the appropriate one. Definitions of such a standard are always difficult, but some characteristics can be highlighted.¹¹ Effective competition:

- is more than the mere threat of competition—it requires competitors active in the market, holding a reasonably sustainable market position¹²
- requires that, over the long run, prices are determined by underlying costs rather than the existence of market power
- requires that barriers to entry are sufficiently low and that the use of market power or collusive behaviour will be competed away in the long run
- requires that there be ‘independent rivalry in all dimensions of the price/product/service [package]’¹³
- does not preclude one party holding a degree of market power from time to time, but that power should ‘pose no significant risk to present and future competition’.¹⁴

These five factors are indicators of the extent to which competition constrains market participants to supply a specific **product** at a high quality and at a price that is based on **cost**. This definition of effective competition, however, requires that the relevant product and costs be identified.

For example, if the product is defined as an asymmetric digital subscriber line (ADSL) internet service based on resale of Telstra’s wholesale service, then the retail price should be constrained close to the **wholesale** plus resale costs of the product; competitors should hold sufficient market share so that they can sustain retail competition; it should be reasonably practical for a new entrant to acquire the wholesale service and to resell it; there should be competition relating to the quality of retail services—such as billing—and the wholesaler should not pose a significant threat to the continued functioning of the market.

A broader definition of the product as a broadband internet service supplied using the unconditioned local loop service (ULLS) would, however, lead to a different assessment of competition. Effective competition at this level would, for example, require that prices be constrained more closely to the **underlying cost** of ADSL supply rather than to the **wholesale** cost. It would also require a reasonable level of competition across the technology used and therefore the speed and quality of connection supplied.

Consequently, the level of competition can be assessed in terms of different levels or different products. It is possible, for example, to find that there is effective competition in a market at the level of access/wholesale-resale, but that there is not effective competition in a market that is characterised by a facilities-based approach. Such a finding would suggest that the participants in the market are

11 This is not intended to be an exhaustive characterisation of effective competition.

12 Olivier Boylaud and Giuseppe Nicoletti, ‘Regulation, market structure and performance in telecommunications’, *OECD Economics Studies*, no. 32, 2001/1.

13 *Re Queensland Co-operative Milling Association Ltd and Defiance Holding Ltd* (1976) 25 FLR 169.

14 *ibid.*, p. 42. In general, however, market power must not be used in a way that would constitute a ‘misuse of market power’.

making good use of the access and wholesale facilities and competing on this ground, but that a better competitive outcome may be available if there was more facilities-based competition.

This definition means that there are many levels at which competition may operate; moving from a complete reliance on wholesale/resale, through the competitive supply of various network elements, to a complete facilities-based model. In this context, one of the significant findings of this report is that the benefits flowing from access/wholesale competition are starting to abate. Further gains can therefore only be made if there is significant progress toward the next level of competition further up the value chain. The ability for the market to make this progress is another important aspect of effective competition, as is the role of regulation in facilitating such an outcome. While it may be possible to say that a market is competitive at, for example, the access level, the activities of some market participants and particular market structure may present a threat to the ongoing development of new levels of competition. Thus part of the analysis of effective competition must centre on whether there are the appropriate conditions, both competitive and regulatory, to foster dynamic improvements and not just static competition at the current level.

2.2.2 Sustainable competition

The sustainability of competition is a second important consideration which may be defined on several different levels. As a starting point, competition is not sustainable if the firms that are currently competing are not viable in the long run. Suppose a market was characterised by two firms competing on the price of a homogenous product and that one firm had a 100 per cent market share when competition begins. Suppose also that consumers incur a small switching cost to move suppliers. Competition in such a market would lead to the incumbent retaining 100 per cent market share and pricing that approaches cost.¹⁵ This market would, however, not be **sustainably** competitive because the second firm would eventually go out of business and cease posing a competitive constraint.¹⁶ This aspect of sustainable competition is captured in the first requirement for effective competition above. This report will refer to this notion as **short-run** sustainability. This criterion also suggests that the mere potential for entry is insufficient; there must be actual entry that has tested the various competitive strategies that are available and impacted on the incumbent's position.

A second definition of sustainable competition acknowledges one of the fundamental objectives of telecommunications policy—**deregulation**, that is the removal of regulation. Using this as a starting point, a market may be said to be sustainably competitive if the benefits that have already accrued would not be lost with the removal of regulation. This test is a measure of the extent to which the market relies on regulation and the potential for sustained competition in a deregulated environment. This report will refer to such an outcome as sustainable or long-run sustainable competition.

¹⁵ In economic terms this is the outcome of a model of Bertrand competition.

¹⁶ Some may argue that this market is 'perfectly contestable'. However, the ACCC would be unlikely to state that such a market is competitive given the real world costs of entry and exit. The model given in the text is also clearly unrealistic.

2.2.3 Assessing effective and sustainable competition

There are several partial indicators of effective and sustainable competition. Overall, however, the operative question is whether the market will allow the entry of a sufficient number of sustainable competitors.

Barriers to entry are paramount in the assessment of effective competition. If there are no barriers to entry then positive profits will lead to entry and a consequent erosion of profits and reduction in market power.¹⁷ It is difficult to give an exact definition of a barrier to entry but generally a barrier is anything that would deter or prevent entry when that entry would lead to more competition and a reduction in price.¹⁸ The effect of a particular barrier will depend, to a great degree, on the totality of market structure and is a pragmatic assessment. Switching costs, sunk costs, increasing returns to scale, low cost rivals and bundling¹⁹ may, however, all be barriers to entry in the appropriate situation and will be discussed below.

Market shares offer additional information for the assessment of effective competition. First, market shares can be used as a measure of the short-run sustainability of competition. That is, if current competitors have reached a reasonable level of market penetration, they are more likely to continue in the industry and pose an ongoing competitive constraint.²⁰ Second, market shares may be indicative of the overall level of competition. Specifically, a market that is characterised by one large firm, many small firms and some barriers to entry would indicate potential for price leadership. However care must be taken because, as noted above a high level of concentration may only indicate that the incumbent began with a 100 per cent market share. Third, falling market shares would seem to be reasonable evidence of at least a minimal degree of competition.

The number of competitors may also be useful. Following the economic theory of oligopoly pricing, a small number of competitors, combined with significant barriers to entry, would tend to suggest that competition is unlikely to be as fierce as it may be.²¹ It is not clear how many firms would be required to avoid this outcome but in general, the lower the absolute number the more important is ongoing observation and regulatory control.

Consistent high margins between cost and price also indicate a lack of competition, although, as suggested above, in the absence of barriers to entry it is unlikely that high profits will remain over time. High margins nevertheless are cause for concern and indicate the need to carefully consider the extent of barriers to entry.

17 A useful discussion on defining barriers to entry is provided by R Preston McAfee, Hugo M Mialon and Michael A Williams, 'What is a barrier to entry', *American Economic Review*, 94(2), pp. 461–5.

18 This very rough definition perhaps begs the question but, in line with the pragmatic approach taken in this report, a more thorough assessment will be given in each case.

19 See Barry Nalebuff, 'Bundling as an entry barrier', *Quarterly Journal of Economics*, 119(1), 2004, pp. 159–87.

20 For a discussion of the importance of market share in pushing down prices in telecommunications see Olivier Boylaud and Giuseppe Nicoletti, 'Regulation, market structure and performance in telecommunications', *OECD Economics Studies*, no. 32, 2001/1.

21 Care must, however, be taken with this point. As John Sutton points out, more vigorous competition will not only lead to a smaller number of entrants, but also to lower prices. It would be hard to suggest that a market that is vigorously competitive is not satisfactory because there are not enough entrants. Significant barriers to entry are therefore a prerequisite for the use of this measure. That said, a market consisting of only two or three players will naturally attract more attention. See John Sutton, *Sunk costs and market structure*, MA: MIT Press, 1991.

Price may also be an indicator of competition. It can be argued that strong price decreases without any sign of predatory behaviour are an indicator of increased competition. Small price decreases and increases, however, are less revealing. Price increases may reflect changes in customer preference, rebalancing or even increased service functionality. Small price decreases on the other hand may only indicate modest changes in factor productivity and may not indicate anything about the level of competition. A slowing in price movements may also indicate that a market has reached a long-run competitive equilibrium. It is also worth noting that Telstra continues to be subject to price controls and that this may be the most direct cause of price decreases.

The level of horizontal and vertical integration will also be relevant to competitive analysis. This report emphasises the impact of integration on the likelihood that competition will develop at higher levels of the value chain.

The type of competition will also be relevant. The ACCC regards facilities-based competition as more likely to be long-run sustainably competitive. It should, however, be noted that this does not require that all competitors make use of a facilities-based model. It may be the case that a few facilities-based entrants competitively provide an access service to a downstream market. An example of this is the market for wholesale inter-capital transmission which the ACCC has previously stated to be effectively competitive.²²

Facilities-based competition is important in its own right because, as noted above, competition relates to supply of more of the end-to-end service and therefore more elements of the price/product/service package. Facilities-based providers have to compete in how and when they develop new services and invest in their networks. By contrast, access regulation, and particularly wholesale service-based approaches, can only go so far in providing this impetus, since competitors rely more heavily on incumbent services and facilities to compete. That said, as noted above, it is entirely possible that a market is effectively competitive in terms of access and wholesale competition, while not sustainably competitive as a facilities-based market.

While stressing the importance of facilities-based competition, the ACCC regards access-based competition as an important part of, as well as a precursor to, greater facilities-based competition in the longer term. One approach, for example, suggests that competition will slowly move toward lower level access services and eventually to the use of stand-alone facilities. Access regulation itself derives from a recognition that in some circumstances, associated with significant scale economies, facilities-based competition is not viable or only partially so. A finding that a market is effectively competitive at the access/wholesale level therefore suggests that there is increasing potential for facilities-based competition, or that competition at the current level has gone as far as it can.

22 ACCC, *Telecommunications competitive safeguards for the 2002–03 financial year*, 31 May 2004, p. 16.

2.3 State of competition in telecommunications markets

In accordance with the ACCC's past practice, the state of competition is assessed on a service-by-service basis. This should not, however, be taken as a definitive view as to the boundaries of particular markets. In some cases the markets may be more granulated, based, for example, on consideration of geography and consumer types and in other cases more aggregated, due to bundling and substitution possibilities. In general, market boundaries are subject to change and are contingent on current modes of competition and directions in regulation. For example, given current market developments, fixed-line competition may be limited to one market, that of a bundle of local, long-distance and fixed-to-mobile calls. This situation, however, is perhaps transient and related to current access prices and market dynamics.

2.4 Fixed-line telecommunications services

Fixed-line services consist of a number of sub-services, which combined, provide a full service. A full service consists of: basic access, which is charged on the basis of a connection fee and monthly line rental; local calls, which must be provided on a per-call rate; national long-distance or STD calls; international or IDD calls; and fixed-to-mobile (FTM) calls. The first two services are usually bundled together and make up the local telecommunications market.

2.4.1 The local telecommunications market

Basic access can be provided using one of several networks. Telstra has a near ubiquitous copper access network; Telstra also owns a hybrid fibre coaxial cable (HFC) network that passes approximately 2.5 million homes (although this is not used to provide basic telephony services); Optus owns an HFC network that passes approximately 2.2 million homes—most of these are the same as those passed by Telstra's HFC network—and there are several other smaller networks in CBDs and some regional areas.

Basic access is a prerequisite for consuming all other fixed-line products and also ADSL broadband. Priced between \$25 and \$50 per month, it is also a substantial portion of an average telephony bill. Basic access is also considered to be a natural monopoly. That is, it is cheaper for basic access to be provided by one provider than by many. The ACCC would therefore not like to encourage inefficient duplication of the copper customer access network (CAN), but the result is that the vast majority—up to 88 per cent—of Australian homes and businesses rely on a telephony service provided using Telstra's CAN. Consequently, while market operators with their own networks may be of increasing importance in the future, the most important characteristic of local telecommunications is the dominance of Telstra.

At 30 June 2004 there were 12 competitors in the retail basic-access and line-rental market: Telstra, Optus, AAPT, Primus, Powertel, TransACT, Macquarie, RSL COM, Neighbourhood Cable, Comindico, Kooee and MCI Worldcom. Of these, Macquarie, RSL COM and Powertel sell exclusively into the business market, Comindico has been placed in receivership and neighbourhood cable competes only in specific regional markets.

Current market arrangements allow for three competitive models for the resale of basic access and local calls. First, a selection of access and wholesale services—the local carriage service, local PSTN origination and termination (PSTN OTA) and domestic PSTN OTA—can be bought from Telstra and used to sell local calls. These services are all declared services and must be supplied to access seekers on terms that satisfy the standard access obligations (SAOs).²³ Telstra also offers a wholesale line-rental product. This product is not declared and essentially Telstra charges the provider retail rates, but allows for integrated billing. Second, a competitor may rent the ULL from Telstra and use its own or others' infrastructure to provide basic access, local calls and a number of other products. Finally, there is potential for competition from other networks and new technologies.

Before discussing the merits of each model, it should be noted that the majority of competition in local telecommunications is based on resale. The ACCC's 2003–04 price changes report shows that prices for PSTN services (comprising all fixed-line services) rose by 0.2 per cent in 2003–04 following a 1 per cent rise in 2002–03. In this context the ACA reported that the benefits flowing from the telecommunications regime have 'generally stabilised over the last two years'.²⁴ Such a finding may indicate that the benefits of access-based competition are beginning to plateau, although further price reductions can be expected as access prices fall. Long-distance prices can, for example, be expected to fall as the access deficit contribution (ADC) is removed from the price of PSTN OTA. Further gains from competition must therefore be realised through greater competition further into the network; allowing consumers the benefits of facilities and quasi-facilities—i.e. ULLS/line sharing service-based competition.

2.4.2 Local call and basic access resale

Imputation testing carried out by the ACCC shows that competitors reselling only wholesale line rental and the local carriage service are not able to make a profit.²⁵ Consequently a local telecommunications only entry strategy is not a viable competitive option and resellers bundle local calls with other services, usually national long-distance, international (together long-distance services) and fixed-to-mobile (FTM).²⁶ All of the companies mentioned above have taken this option, and it is possible to conclude that the only effective competitive model for local telecommunications is to be a full service provider.

23 *Trade Practices Act 1974* (Cth), s. 152AR.

24 ACA, *Telecommunications performance report 2003–04*, December 2004, p. 31.

25 For example, ACCC, *Imputation testing report relating to the accounting separation of Telstra for the September quarter 2004*, December 2004, table 2.1. This report confirms an outcome that has been observed for several years.

26 There is the possibility of competitive entry as a local-call-only provider as long as there is a preselect provider selling sufficiently cheap long-distance and fixed-to-mobile calls to make it worthwhile for the customer to buy higher priced local calls and basic access. This model, however, does not seem to have developed. There are three possible explanations. First, local calls and basic access prices may be the most important pricing variables for the consumer—meaning the consumer would be unlikely to accept higher local telecommunications prices in return for cheaper long-distance calls. In this context local calls can be compared to bread in a supermarket—communicating important information to consumers about the overall quality and pricing of the operator. (The role of bread in communicating overall pricing has been discussed in *ACCC v Australian Safeway Stores Pty LTD* [2003] FAFCR 149, [10]). Second, it is possible that the current discounts offered by Telstra mean that it is not possible for two separate competitors to replicate Telstra's bundles. The current imputation tests are, however, too aggregated to come to a definitive opinion. Third, the necessity of relying on ongoing cheap pricing provided by an independent preselect operator may be a significant risk and therefore a barrier to entry.

Market shares show a high degree of concentration. The ACA estimates that, as at June 2004, 88 per cent of standard telephone services (STS) were supplied on Telstra's network, 10 per cent are supplied on Optus' network and the remainder is taken up by small players.²⁷ Of Telstra's 88 per cent wholesale market share, Telstra estimates that it supplies 75 per cent of the market through its own retail arm, meaning 13 per cent is supplied by resellers of Telstra's wholesale basic access service.²⁸ In terms of access lines, Australia is eighth in the OECD for market share held by new entrants and well behind the leading players, such as the UK, Hungary and the US.²⁹ These numbers, while potentially reflecting Telstra and Optus' positions as incumbent duopolists, raise concern that existing competition is not sustainable in the short run.

At most, 13 per cent of basic lines are provided by companies other than Optus and Telstra and this is likely to be an overestimate as it includes Optus' resale activities. The ACCC's telecommunications market indicator report 2002–03 also indicates that only 7 per cent of basic access revenue and 9 per cent of local call revenue was earned by competitors other than Telstra and Optus in that financial year. Finally, the ACA states that other carriers provide only 900 000 of a total of 9.3 million basic access lines that are sold under the customer service guarantee.

This small market share is divided between up to 10 other players, many of whom are relatively recent entrants. Given the recent failures of Comindico and OneTel, there is significant potential that a portion of the current competitors are not sustainable. If these smaller firms fail then the market will revert back to an oligopoly, and many of the existing competitive gains might be lost. These considerations militate against considering the market to be effectively competitive at the access/wholesale resale level. However, as noted above, barring effective barriers to entry, there is a presumption that firms will be able to enter profitably and constrain pricing. It is therefore necessary to consider the features of the market, if any, that make it less than effectively competitive.

As noted above, given prevailing price/cost relationships, a prospective competitor would need to provide a full service.³⁰ Telstra's most recent imputation tests indicate that an equally efficient access seeker providing a full fixed-line service could earn a margin of \$1.50 per business customer and just over \$4 per residential customer, per month.³¹ This indicates the potential for competitive entry. Significant factors, however, militate against this outcome.

It is evident, and has been well documented, that consumers display what has been described as a 'status quo bias', preferring not to make changes to consumption patterns unless there is a compelling reason to do so.³² This bias is in addition to actual switching costs faced by consumers

27 ACA, op. cit., pp. 58–9.

28 This figure is open to some interpretation. The ACA reports that 72 per cent of basic access lines are supplied by Telstra to the retail market. Telstra, however, suggests in its annual report that it has a market share of 75 per cent. The ACA, on the other hand, states that Telstra has a market share of 78 per cent of the basic access lines that fall under the Customer Service Guarantee, that is, services provided to customers who have 5 lines or less—which essentially relates to residential and small business lines.

29 Figures are for 2001 share of access lines. See OECD, *Economics surveys: Australia*, December 2004, p. 111.

30 This requirement is of considerable competitive concern and is discussed further in the conclusion of this report.

31 ACCC, *Imputation testing report relating to the accounting separation of Telstra for the September quarter 2004*, December 2004, table 2.1.

32 William Samuelson & Richard Zeckhauser, 'Status quo bias in decision making', *Journal of risk and uncertainty* 1(1), 1988, p. 7. For some brief comments on the application of status quo bias to telecommunications see Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue and Matthew Rabin, 'Regulation for conservatives: behavioural economics and the case for "asymmetric paternalism"', *University of Pennsylvania Law Review*, 151, pp. 1211–54, p. 1225.

and will be particularly strong in telecommunications markets because consumers are locked in to a contract and must make an **active** decision to change suppliers. This is in contrast to other markets where consumers must make a decision every time they buy a product.³³ The combination of status quo bias and switching costs favours Telstra as the default provider of telecommunications. A potential competitor would need to provide an inducement, usually in the form of a lower price,³⁴ to overcome the bias. This effect is, of itself, a barrier to entry as it requires that the price charged by the entrant be lower than Telstra's price.³⁵

Status quo bias also implies that a significant portion of Telstra's customers are currently buying a plan that is more expensive than their optimal plan. Typically this means they are not buying a bundled plan. In fact, the ACA estimates that only 33 per cent of consumers buy bundled plans despite the fact that a bundle offers discounts of up to \$25 per month. When these consumers consider moving to a competitive provider, however, they are likely to compare the competitor's offering to the Telstra **bundled** plan. This implies that there is in fact less profit to be made as a total service provider than the imputation test indicates and that there may be a barrier to entry. This occurs because the competitive entrant must compete against the bundled prices, but Telstra's current revenue includes customers who have not yet moved on to bundled plans. These dynamics will be a focus of the ACCC's upcoming review of local call regulation.

In addition to the issues raised by switching costs, it is likely that there are scale economies associated with the provision of telecommunications. It would, for example, be necessary to buy a billing system of a reasonable size leading to falling average costs.³⁶ While it can be shown that these costs are not a barrier to entry alone when combined with the reluctance of consumers to change suppliers, scale economies can act as a barrier to entry and exacerbate the impact of the status quo bias.³⁷ For example, a firm may need to sell below cost while waiting for market share to push average costs down, but may fail before that point arrives.³⁸ This possibility is a significant risk that would tend to deter entry.

There may also be significant sunk costs involved in setting up as a full service provider. Building market share requires marketing services and contracting for supply of necessary services among other establishment costs. These sunk costs may be high and are exacerbated by the need to enter as a full service operator.³⁹ The presence of sunk costs makes entry less appealing as the cost of failure is higher.⁴⁰ Because the incumbent is also likely to have a large level of sunk costs, there is significant potential for aggressive post-entry pricing, also raising barriers to entry.

33 While conceptually similar to switching costs, status quo bias is a psychological phenomenon which suggests that, even if the saving is large enough to cover the actual costs of switching, the consumer may choose to favour the status quo.

34 This section is currently considering only access-based competition, where there is little potential for product quality improvements to lure away consumers.

35 This point is supported by R Preston McAfee, Hugo M Mialon and Michael A Williams, 'What is a barrier to entry', *American Economic Review*, 94(2), pp. 461–5, p. 464.

36 It is also likely that there are quantity discounts available on services such as long-distance termination, backhaul and the LCS.

37 R Preston McAfee, Hugo M Mialon and Michael A Williams, loc. cit., pp. 461–5, p. 464.

38 The incumbent may also pursue anti-competitive strategies to maintain market share. See discussion of ADSL pricing in the ULLS section below.

39 Under current preselect arrangements a full service operator must provide the full bundle of national long-distance, international and FTM services. Contracts would therefore need to be made with, at a minimum, Telstra, Optus, Vodafone, an intra-capital and inter-regional transmission provider and for an international termination service. Such contracting costs are likely to be high because, as discussed below, these competitors are all likely to see the potential entrant as a threat.

40 The presence of sunk costs will also add to the effect of scale economies identified earlier.

The entrant must also rely on Telstra, one of its main competitors, to provide all services as well as maintenance and churn.⁴¹ While these may be supplied in a non-discriminatory manner by Telstra, the mere potential for discrimination will lead to a perceived risk; a risk that capital markets are not likely to ignore.⁴² There is also evidence that the access products provided by Telstra differ from those which it provides to itself. For example, Telstra currently provides home messages 101 free with its basic access service. Access seekers, however, cannot currently buy a similar product from Telstra.⁴³ This differential may act as a barrier to entry if it is not possible for access seekers to replicate Telstra's offerings.

The potential competitor will also be aware that Telstra and Optus face costs which are significantly below its own. The costs of FTM termination are above Telstra's costs as are the PSTN OTA charges.⁴⁴ Added to this, existing access seekers apparently receive quantity discounts on PSTN OTA and local call service (LCS) prices; these will not be available to the entrant. While the ACCC believes that price discrimination of this kind can enhance static economic efficiency, this may insulate current market participants from the threat of entry.

Each of these barriers alone may not seem insurmountable, but when considered in totality they form a significant barrier to entry. It is therefore not possible to conclude that the local telecommunications market is effectively competitive even at the level of basic access and local call resale. It should, however, be noted that when local telecommunications is considered in conjunction with other fixed-line services, the current regime provides a level of competition that has produced pricing which is close to access-based cost.⁴⁵

41 In such a circumstance, economic theory suggests that the incumbent will face a strong incentive to provide lower quality or higher cost services. This discrimination has been termed 'sabotage'. See for example, T Randolph Beard, David L Kaserman and John W Mayo, 'Regulation, vertical integration and sabotage', *Journal of Industrial Economics*, 49, 2001, pp. 319–33; Alvaro Bustos and Alexander Galetovic, 'Vertical integration and sabotage in regulated industries', June 2003, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=474621; Nicholas Economides, 'The incentives for non-price discrimination by an input monopolist', *International Journal of Industrial Organization*, 16, 1998, pp. 271–84; David Mandy, 'Killing the goose that laid the golden egg: only the data knows whether sabotage pays', *Journal of Regulatory Economics*, 17, 2000, pp. 152–72; David S Sibley and Dennis L Weiseman, 'Raising rivals' costs: the entry of an upstream monopolist in downstream markets', *Information Economics and Policy*, 10, 1998, pp. 451–70; and Dennis L Weisman and Jaesung Kang, 'Incentives for discrimination when upstream monopolists participate in downstream markets', *Journal of Regulatory Economics*, 20, 2001, pp. 125–39, among other contributions. It should be noted that one of the implications of this literature is that access prices should be set above the optimal non-sabotage level, see Jan Y Sand, 'Regulation with non-price discrimination', *International Journal of Industrial Organization*, 22, 2004, pp. 1289–307. The ACCC, however, does not price access according to economically optimal pricing rules which would, in many cases, suggest either an efficient component pricing rule (ECPR) type approach or below marginal cost pricing. This is because the ACCC must apply a more comprehensive set of criteria that takes account of other factors in addition to economic efficiency. The ACCC therefore considers that its prices are above the economically optimal prices and that Sand's argument does not apply. However, even if there is an argument for higher prices, the ACCC does not accept that end-users should face higher prices because the incumbent is likely to discriminate.

42 Additional discussion on the potential for discriminatory supply can be found below in the section on ULLS-based competition.

43 AAPT Ltd, *Submission by AAPT Ltd to the Australian Competition and Consumer Commission in response to the Australian Competition and Consumer Commission's review of price control arrangements discussion paper dated June 2004*, August 2004, p. 9.

44 This may act as a deterrent to entry because of the risk to a small competitor if there is price competition between the firms which own mobile networks.

45 ACCC analysis indicates that there are still high margins across the bundle when considering the underlying costs faced by Telstra and that these margins may be increasing.

Currently, the majority of fixed-line competition is between full-service companies providing a bundle of both local telecommunications and long-distance and FTM services.⁴⁶ Given the barriers to entry for a full-service entrant, and the low market shares that are held by the current competitive providers, there is cause for concern that the market for fixed-line services is, in general, less than competitive. One interpretation would be that current competition is weak, characterised by barriers to entry and small market shares, and that the historical cause of price changes has been the price cap regime rather than the influx of competition. The low margins shown in recent imputation reports may therefore be picking up the effect of the price cap, rather than competitive entry. Consequently there is some ambiguity surrounding the cause of the current low prices and margins.

2.4.3 ULLS-based competition

The ULLS allows quasi facilities-based competition in the local market. As such, entrants are able to compete across more aspects of the price/product/service package. A ULLS competitor may, for example, offer greater functionality over the basic access line or voice services at lower cost using VoIP. Further, provisioning using ULLS means that competitive entrants' costs are more reflective of the underlying costs of production, and ULLS-based entrants have greater cost flexibility. The ULLS therefore offers the next level of competition in local and other fixed-line markets; and potentially provides long-term sustainability allowing removal of intensive regulation of the local call service and related products.

ULLS uptake to this date has been disappointing. ACCC figures suggest that, as at December 2004, only around 30 000 ULL services had been taken up by access seekers, and that these are mostly in the business market. The ACCC believes that this number will increase in the coming financial year, but recognises that there are several difficulties with the quasi facilities-based approach.

Using the ULL requires substantial infrastructure investment and considerable risk. The ACCC has recognised that one model for reducing this risk is to build market share through resale of LCS, basic access, long-distance services, FTM and ADSL (broadband), before committing to ULLS.⁴⁷ This model is easily disrupted if it is hard to build market share, a situation that can be brought on by aggressive pricing by the incumbent. As noted above, consumers tend to have a status quo bias, a competitor wishing to build market share will have to offer a deal that is better than that offered by the incumbent. This may be precluded if incumbent pricing is difficult to match.

In this context, Telstra supplied 290 000 new wholesale basic access services this year.⁴⁸ This number is very similar to the number of consumers the ACCC believes took up ADSL services with access seekers over this period. Optus recently reported that it has '... achieved exceptionally high bundling rates for its DSL base with over 95 per cent of DSL customers continuing to choose Optus for their home phone services'.⁴⁹ It is possible to argue that consumers who decide to buy ADSL or broadband

46 The ACA reports that 75 per cent of residential consumers and 76 per cent of small business consumers are currently buying all fixed-line services from a single supplier. See, ACA, *Consumer satisfaction survey 2004*, Special Report No. 14, August 2004, figure 11.

47 See, for example, ACCC, *Assessment of Telstra's undertakings for PSTN, ULLS and LCS: draft decision*, October 2004, pp. 68–9.

48 ACA, *Telecommunications performance report 2003–2004*, December 2004, p. 59. A small number of basic access services are supplied using alternate networks, predominantly in CBD areas.

49 See Optus press release, 'Optus smashes through 100 000 DSL customer mark', 1 February 2005.

services take the opportunity to reassess their overall fixed-line arrangements and that this acts to overcome status quo bias. As a result, Telstra's aggressive, potentially anti-competitive, pricing in the ADSL market is likely to reduce the number of consumers switching away from the incumbent at this important juncture. To the extent that this prevents other equally efficient competitors from winning customers, Telstra's pricing policy will reduce the potential for competitors to build market share and have an adverse effect on the long-term prospect for ULLS uptake, and consequently the long-term development of competition in the fixed-line market.

A ULLS competitor also relies on Telstra for many services. Use of the ULLS access service entails, among other things, monthly rental, a connection charge, payment for Telecommunications Exchange Building Access (TEBA), electricity charges, service qualification and customer churn. Of these, only the monthly rental is currently the subject of model pricing by the ACCC. While all these services must be provided by Telstra on a non-discriminatory basis,⁵⁰ Telstra can argue that it does not provide these services to itself and therefore no strict standard can be applied. Provision of the services will therefore be the subject of negotiation and potential arbitration by the ACCC.⁵¹ These negotiations alone are likely to add to costs of ULL up-take and, in general, the incumbent will have little incentive to be cooperative.⁵²

The ACCC has powers to enforce non-discriminatory supply and to arbitrate disputes. These powers, however, rely on ex post monitoring and enforcement through the Federal Court or potentially lengthy arbitration processes.⁵³ Using this system is difficult because: as noted above, Telstra does not supply the service to itself and there is therefore no objective standard; court enforcement requires that there be a reasonable amount of discrimination before it is cost-effective to litigate; discriminatory supply is difficult to observe and requires intensive monitoring, in some cases not even the access seekers will be aware that they are not being offered the appropriate service; and the time spent litigating may do serious damage to the business case for ULL uptake. These limitations are not of major concern when an entrant wishes to pursue a slow expansion policy, but will be of more concern when a large scale changeover is considered. The ACCC will be considering Telstra's current ULLS and LSS undertakings in 2005 with specific emphasis on non-price issues during this process. Industry dialogue regarding non-price issues is also a current focus for the ACCC.

There is cause for concern in the most recent imputation analysis relating to the ULLS. For the September quarter of 2004, the first analysis performed for this service, Telstra failed the imputation test on the ULLS by over 200 per cent. While this figure must be interpreted with care, as noted in the report, it does indicate that competition using the ULLS will be difficult in the residential sector and may not necessarily provide a mass-market solution. That said, the ACCC will be looking more closely at ULLS provisioning issues in 2005 to reduce the advantages of Telstra's incumbency and overcoming the status quo bias to promote better competitive outcomes in the short to medium term.

Overall, the limited uptake of the ULL service, coupled with the difficulties inherent in its use, mean that the ULLS-based model does not currently provide an effective or sustainable competitive constraint.

50 *Trade Practice Act 1974* (Cwlth), s. 152AR.

51 An arbitration relating to connection charges for LSS is currently before the Commission.

52 There is significant potential for sabotage in this area, see footnote 41.

53 *Trade Practices Act 1974* (Cwlth), Part XIC, division 3.

2.4.4 New technologies

In part, the competitive potential of the ULLS relies on the prospect for competitive deployment of low-cost voice services using voice-over IP protocol (VoIP). It is often argued that wireless technology—providing voice services using VoIP—presents the possibility for an alternate local loop that does not display the same natural monopoly characteristics as Telstra's CAN, and can therefore reduce reliance on the CAN. There are, however, some initial difficulties. For example, wireless technology has only been deployed in selected areas and its effectiveness as a mass-market solution for both broadband and voice is still unproven. There are also some questions about the reliability of VoIP—at least as currently configured—for the mass market.⁵⁴ These concerns are relevant whether VoIP is supplied over the ULLS or by using wireless. It is therefore not clear that these new technologies will be a true substitute for the more reliable copper-based, circuit-switched, fixed-line services, at least in the short to medium term.

Further, fibre to the home (FTTH)⁵⁵ offers a superior, 'future proof', technology that will likely be economic across a wider range of geographic areas in the next 10 to 15 years. Analysts have suggested that FTTH will have a lower incremental cost than copper in the future. As a result, for bandwidth intensive applications at least, it will be very hard for any other technology to compete with this option.⁵⁶ While FTTH is unlikely to have a competitive effect in the foreseeable future, in the longer term it will start to cast an economic shadow which may call into doubt the long-term viability of investment in alternative (local loop) infrastructure.⁵⁷

It has also been argued that mobile service may increasingly constrain the pricing of fixed-line services. In this context, the ACCC estimates that approximately 20 per cent of total call minutes in Australia are mobile call minutes.⁵⁸ There is also potential that this number will increase as the availability of cheaper calls, often based on 'bucket plans' reduces the 'mobility premium'. The ACCC, however, considers it unlikely that, in a country where copper-based telecommunications are ubiquitous, fixed-line services would be abandoned to any significant degree in the near future. Most consumers still rely on the home phone for cheaper calls and everyday use, and it is still not the case that mobile calls offer the same level of quality. This reliance on fixed-line is compounded by the requirement that a consumer take basic access to have an ADSL or dial-up internet connection. Having paid for basic access, a consumer is likely to make use of the typically cheap calls that come with such service bundles. The mobility premium has only started to decrease in the past year and no effects have yet been observed in the price changes as reported in the ACCC's 2003–04 price changes report. It is therefore too early to speculate on the current significance of substitution from fixed-to-mobile, but notes that it is not self-evident that fixed-line prices will fall as a result of mobile competition.

54 See Ponderosa Communications Pty Ltd, *Options for supply of telecommunications services (technologies and their implications) a report for the Australian Competition and Consumer Commission*, October 2004, indicating that while VoIP may be a viable service in the long run it is not well suited to providing a primary voice service, at least as it is currently configured.

55 Or to the curb.

56 In his briefing to analysts, Ted Pretty of Telstra indicated that 'aggressive industry forecasts for Australia suggest by 2020, around 6 million households would be served by Fibre to the Premises (FTTP) and 2 million still serviced by copper.' See Ponderosa Communications Pty Ltd, loc. cit.

57 Wireless services require a high level of investment and as FTTH becomes viable over larger areas the business case for wireless rollout becomes less attractive.

58 Estimated using data from ACCC telecommunications market indicator report 2002–03, June 2004.

These views are perhaps more pessimistic than those held by some analysts who suggest that potential for substitution toward competitive options, such as mobiles and new technology, may challenge Telstra's dominance. That view, however, is based on an optimistic view of the market over the long term and in particular a positive perspective of the role played by substitution toward mobile, VoIP and wireless services. The ACCC, by contrast, still sees significant threats to the development of competition across some telecommunications markets and, while future developments may remedy this, it would be naive to consider such developments inevitable in the absence of appropriate regulatory scrutiny. In particular, many of the more optimistic market analyses tend to discount Telstra's ability to respond to a loss in market share through leveraging, cross-subsidisation and various forms of discrimination in the access and retail market.

2.4.5 Competition in corporate markets

The ACCC recently released the first in a series of reports that will assess the level of competition in the corporate market.⁵⁹ It was particularly concerned about the potential for highly aggressive—anti-competitive—pricing and non-price discrimination in these markets.

That this market is very 'competitive' is borne out by strong price decreases shown in the ACCC's 2003–04 pricing report. While price decreases may be interpreted as a pro-competitive signal, it is not clear that it will necessarily result in sustainably competitive outcomes in the corporate sector and may be indicative of several factors. Taking a positive view, the decreases may indicate that greater facilities-based competition is leading to a strong competitive outcome. In this context it is possible that prices are falling faster than in residential markets because corporate consumers are more willing to adopt new, low-cost technologies such as VoIP. A more pessimistic observer may, however, consider that price falls indicate that Telstra is attempting to hold on to its dominant position in a high-value market.

The ACCC is undertaking continued monitoring of the market to ensure that the competition continues to provide low prices but does not threaten the sustainability of current competitors. The ACCC's recent recommendation that these services be removed from the price cap regime reduces the possibility that fierce competition in corporate markets can be used to raise prices in the less competitive small business and residential markets. Overall, the ACCC believes that current competition in corporate markets is characterised by greater levels of facilities-based competition and is therefore more effective.

2.4.6 Assessment of local telecommunications competition

Overall, the ACCC concludes that, while the market for corporate telecommunications is competitive, the remainder of the market for local telecommunications is not effectively or sustainably competitive.

Injecting more competition into this market could proceed along several different lines. First, status quo bias is a significant barrier to gaining market share and may be a barrier to entry. Encouraging more switching may reduce barriers to entry.⁶⁰ Second, reliance on Telstra for provision of

⁵⁹ ACCC, *Competition in the corporation customer segment of telecommunications market: July–December 2003*, June 2004.

⁶⁰ Such an approach is discussed at length by the UK regulator Ofcom. See, Ofcom, *Strategic review of telecommunications: phase 2 consultation document*, 18 November 2004, pp. 17–8.

maintenance and ULLS raises the potential for discrimination aimed at raising prices and protecting market share. Addressing this issue is difficult under the current regulatory regime and would require a more proactive regime that enables better information gathering and ex ante assessment of Telstra's actions.⁶¹ Third, the barriers to entry in local telecommunications are exacerbated by the need to enter as a full service provider. The ACCC will be undertaking a full review of the local call service and related issues and will consider this issue as part of that process. Fourth, while it is suggested above that access pricing and infrastructure development are complementary; this situation will not continue indefinitely. At some point, low access prices will deter competitive infrastructure development. If ULLS uptake continues to stall; there may be a case for sun-setting resale and access pricing arrangements in this market. These issues are discussed further in the final section of this report.

2.4.7 National long-distance, fixed-to-mobile and international market

While generally part of the overall market for fixed-line services, the current regime provides three additional ways to compete in the combined national long-distance, international and FTM markets. First, a competitor may enter as a preselect provider, supplying long-distance and FTM services to a consumer who buys basic access and local calls from another provider. Second, a company may enter as an override competitor, offering long-distance calls to consumers that are willing to enter an override code when making long-distance FTM calls. Third, a company may compete through calling cards. The potential for effective competition using each of these options is considered below.

By way of background, it should be noted that these services currently display substantial margins. Telstra's most recent imputation tests indicate that an equally efficient access seeker would earn margins of 69 per cent and 66 per cent in business and residential long-distance respectively, 48 per cent and 41 per cent in business and residential international respectively; and 17 per cent and 36 per cent in business and residential FTM respectively.

The markets are dominated by Telstra which has market shares of 65 per cent in national long-distance, 52 per cent in international and approximately 65 per cent in FTM.⁶² The OECD estimates that in 2001 new entrants accounted for about 38 per cent of the national long-distance market and around 50 per cent of the international market. These figures place Australia 12th and 9th in the OECD respectively.⁶³ This suggests that there is significant potential for continued erosion of Telstra's market shares. Prices have been falling for all services over the past five years with falls of 1.9 per cent in national long-distance, 5.6 per cent in international and 2.2 per cent in FTM over 2003–04.⁶⁴ These price falls are lower than in previous years showing that prices are stabilising. This again indicates that the benefits from competition based purely on access/wholesale resale are abating.

61 Ex ante assessment is important as one of the biggest costs to industry is the time taken to come to a satisfactory outcome.

62 National long-distance and international market shares are taken from Telstra, *Annual report 2004*. Fixed-to-mobile market share is taken from ACCC, *Mobile services review: mobile terminating access service*, June 2004 and are for the 2002–03 financial year.

63 OECD, *Economics surveys: Australia*, December 2004, p. 111.

64 This section of the report makes limited use of price changes in long-distance and international markets. This reflects the fact that they do not incorporate prices paid for calling card calls. A price rise may therefore hide a movement of consumers with more elastic demand toward a calling card and the consequential increase in prices for non-calling card customers.

In general, competitors in these markets must buy both 'transmission capacity' and PSTN 'origination' and/or 'termination' (PSTN OTA). While the market for intercapital transmission is competitive, consisting of at least four facilities-based providers, Telstra dominates the PSTN market and the market for interregional transmission may be less than competitive. The ACCC has recently released its final decision to accept Telstra's PSTN undertaking, which will lead to a reduction in PSTN prices over the next two financial years as the access deficit contribution is removed.⁶⁵ As a result, the ACCC expects to see a further decrease in price for long-distance calls in the coming years. The market for interregional transmission, however, has only few competitors and there is some concern that this impacts negatively on the ability of competitive entrants to offer services to rural and regional Australia.⁶⁶ Addressing this issue may require a reconsideration of long-distance calling zones.

2.4.8 Preselect competition

This option requires that the consumer takes basic access and local calls from Telstra, while long-distance and FTM services are provided by an access seeker.⁶⁷ The access seeker will generally make use of the PSTN OTA access service, the mobile termination access service (MTAS) and intercapital transmission to provide the services. In theory this should allow a small competitive access seeker the opportunity to enter the preselect market and erode whatever profits are being made there.

There are, however, difficulties associated with this model. Telstra will charge the consumer a higher price for basic access and local call services than if the customer preselected long-distance with Telstra⁶⁸ and the consumer will no longer be eligible for Telstra's 'reward options'.⁶⁹ The increase in local call prices and loss of rewards is the penalty to the customer for preselecting another competitor and the preselect competitor must compensate the customer for this loss.

The value of the preselect penalty will depend on the customer's characteristics. For example, a residential consumer that buys only fixed-line telecommunications and makes 120 local calls per month will face a penalty of \$2.40 per month.⁷⁰ A residential consumer who buys one other eligible service⁷¹ from Telstra and makes 160 local calls per month faces a penalty of \$12.95.⁷² At the extreme, a residential consumer that buys two other eligible services and 180 local calls per month will face a monthly penalty of nearly \$27. The penalties are generally greater for business customers.⁷³ In addition to the penalty, the consumer must also forego the convenience of one bill and one provider.

65 ACCC, *Assessment of Telstra's undertakings for PSTN, ULLS and LCS: final decision*, December 2004.

66 A recent report by NATSEM also shows that rural and regional consumers currently spend more on telecommunications than urban consumers. See, *Analysis of expenditure on Telstra telecommunications services: research report for the Australian Competition and Consumer Commission*, January 2005.

67 Current arrangements mean that the consumer must take national long-distance, international and FTM services from the same provider.

68 It is possible to take local calls and basic access from another provider but in general all providers reserve the right to charge higher basic access and local call prices if the consumer does not preselect long distance. Telstra is discussed here as it is the dominant provider.

69 The ACA estimates that 33 per cent of consumers buy in a bundle and are therefore eligible for rewards. This number is increasing. It may therefore seem that rewards are not that important, however, many consumers may not be taking advantage of rewards because they have not recently reconsidered their telecommunications consumption. Consumers that consider moving to a competitive supplier are likely to reconsider all options including taking a bundle and the associated reward. The competitive supplier must therefore compete directly against the bundle.

70 Based on the move from Telstra's 'HomeLine Plus' plan to 'HomeLine Part'.

71 An eligible service is a post-paid mobile service, most ADSL or dial-up internet packages or pay TV.

72 Based on the move from Telstra's 'HomeLine Plus' plan to 'HomeLine Part' and the loss of 50 free local calls on Telstra rewards.

73 Business customers are not discussed explicitly because plans are primarily provided under contract and information about discounts is not in the public domain.

In contrast, Telstra's most recent imputation report shows that providing long-distance and FTM services yields an average profit of \$9.30 per month for a residential customer and \$7.40 for a business customer.⁷⁴ Comparing these figures to the preselect penalty above suggests that it is difficult to make a profit as a preselect provider across a range of customers. Because the imputation reports show only averages, it may still be profitable to provide a preselect service to high-value consumers or consumers whose consumption is skewed towards the more profitable international and long-distance services.⁷⁵ It does mean, however, that preselect cannot be used to target a broad range of customers and is, effectively, a niche market option.

As noted earlier, there are currently 10 competitors that sell local telecommunications. These competitors make a loss on the sale of basic access and local calls, and will in general recoup this loss through higher long-distance and FTM charges. By contrast, a preselect strategy would require lower long-distance and FTM prices to compensate for the preselect penalty. These two strategies seem to be mutually exclusive.⁷⁶ The majority of suppliers have chosen the full service option and the preselect option has only been taken up by some of the smaller competitors operating in niche areas.

It should, however, be noted that these difficulties are less associated with competition in long-distance and FTM markets per se and more related to difficulties in the local call market. For example, if the local call market was competitive and prices approximately equal to cost it is likely that the preselect penalty would be competed away by competitive entrants in the local call market. Consequently it would not be possible to exclude competitors in the preselect market. As the market currently stands, however, when prices for local calls are increased, it is not possible for a competitor to enter the local call market alone and compete to push down prices. This suggests that the current losses in the local call market are a key factor leading to competitive concerns in the preselect market generally.

As noted above, the ACCC will be conducting a review of local call arrangements beginning in early 2005. The review will reconsider existing pricing and service arrangements with the aim of promoting competition in the local call market.

74 These figures are calculated by adding the imputed margin across a bundle of services to the loss that is made on local carriage and dividing by four to get a monthly figure. Figures are from ACCC, *Imputation testing report relating to the accounting separation of Telstra for the September quarter 2004*, December 2004, table 2.1. There is some question as to whether these figures already include the discount that results from Telstra's rewards. However, Telstra's rewards offer a choice of free local calls, free SMS, mobile phone credit or calls from a home phone to a linked mobile. Of these only the last offers a long-distance or FTM service and would therefore affect the revenues which make up the imputation test. The ACCC therefore believes that the imputation test will show a reasonably accurate representation of long-distance and FTM revenues without any discount being subtracted. Further, as noted above, only a portion of customers will be on the Telstra reward plans. Any loss in revenue will therefore only be across these customers. A potential competitor, however, will have to compete against the Telstra bundles even if they wish to win away a competitor who is not currently using a bundle (see also footnote 69). The ACCC therefore believes, based on the ACA estimate that only 33 per cent of consumers buy bundles, that the imputation tests will tend to accurately represent the revenue available, or to overestimate it.

75 To the extent that high volume long-distance and FTM users are also high-value local call and other service users the problems will not disappear.

76 While it would be possible to offer cheaper preselect prices than bundle prices, it does not seem very logical and casual observation shows that it has not occurred.

2.4.9 Override and calling-card competition

A competitor may compete through override by offering a set of national long-distance, international or FTM rates that are available when a consumer dials a four digit override code before the telephone number. The override competitor typically makes up the service by buying PSTN OTA access service, the MTAS and intercity or international transmission capacity. Override competition has several advantages over preselect competition. A consumer can maintain their local call discount and reward options while still buying long-distance and FTM services from an override competitor. There is therefore no equivalent to the preselect penalty. The override competitor is also able to price on a per call basis, rather than locking a consumer in to a contract. Consequently the model offers greater potential for pricing flexibility and targeted discounting.

Override competition is, however, limited in its appeal to consumers. The consumer faces some search costs in finding the override competitor that is most appropriate and must also sign up with the competitor to make use of the service. The consumer must also regularly determine the price of their calls as these may be subject to change. The consumer must also have several telephone bills and will need to dial the four digit code before making the call. To the sophisticated consumer, these difficulties are less significant, however, to the less sophisticated consumer or to the consumer that places high value on convenience or who only makes a limited number of calls, these annoyances may be a significant deterrent. In general it seems that override competition is best suited to consumers who make a large number of calls to a specific destination and are therefore willing to make the effort to use the codes.⁷⁷

Calling-card competition is similar to override competition. The consumer buys a prepaid calling card associated with particular calling rates. Often calling card calls use a VoIP service and may, in many cases, be of lower quality than a standard fixed-line telephone call. The calling card has higher search costs than a regular call and is not well suited to making unplanned or more sporadic calls. They do, however, offer significant cost savings to a consumer who is able to make effective use of them. Such a consumer is likely to be one that buys many phone calls to a particular destination and is therefore willing to take the time to make the comparison between different calling options. A calling card is charged on a pre-paid basis and the consumer must commit to buying a minimum value of calls, usually \$20, to a certain destination.⁷⁸ To many, this will be an excessive upfront expenditure and may be much more than they would spend on calls in the relevant decision-making period.⁷⁹

In general override and calling cards offer a niche competitive option. That they are effective can primarily be seen in the reduced market share held by Telstra and Optus in the long-distance markets as opposed to the local call market.⁸⁰ Further, the options will undoubtedly act as a constraint on prices and allow for easier entry than would be the case for a full-service competitor.⁸¹ It is, however, uncertain as to whether they will have a greater competitive impact in the future.

77 Override competition may be more effective in business markets because large firms are able to use a PABX to automatically dial the appropriate override code. There has, however, been some suggestion that corporate contracts restrict this potential.

78 While calling cards may offer rates to many destinations, they are often significantly cheaper to specific destinations.

79 For example, Telstra's most recent imputation report indicates that an average residential consumer makes only \$5 worth of international calls a month and business consumers only \$2. This is unlikely to justify the upfront purchase of a calling card, especially when that card may only be appropriate for calls to a specific destination.

80 They are less prevalent in the fixed-to-mobile market as discussed below.

81 Unlike full service or preselect options, an override or calling-card competitor does not have to provide the entire bundle of long-distance and FTM services. This means that they can cut entry costs and concentrate on only one market. These markets therefore provide much more potential for a low-cost entry strategy.

2.4.10 State of competition in domestic long-distance and international markets

While entry as a full-service operator has the same difficulties as discussed in the local telecommunications market; there are three other competitive options available in long-distance and international services. While preselect competition is of limited viability it does provide an additional constraint on pricing. The concern is that as bundling grows it will become increasingly difficult to operate as a preselect provider alone. However, as the market currently stands this is a limited, but potentially useful, competitive option.⁸²

The option to compete as a calling-card or override operator presents a simple entry strategy. The entrant can concentrate on high-volume consumers in a specific market and make use of lower cost technologies such as VoIP. The ACCC believes that this form of competition will continue to grow in the future and also notes that because of the low cost of entry, such competition is more likely to allow for faster entry and therefore more likely to be short-run sustainable competition. This is a major advantage over the local market where entry requires the provision of numerous services. The ACA does report, however, that in 2004 only 4 per cent of households and 2 per cent of small business used override codes for making long-distance and FTM calls.⁸³ This indicates that while the threat of override competition may restrain prices, it is not yet a tested competitive constraint and may fall short of being considered sustainable in the short term.

There are therefore signs that the market is maturing and competition is growing. These signs, however, must be measured against the observation that margins are still high. The ACCC believes that growing levels of competition will lead to substantial erosion of these margins at least in the medium term, and that the market is showing encouraging signs of greater competition. This conclusion is, however, a qualified one. As noted above, the inability to enter as a local-service only competitor means that long-distance services subsidise local telecommunications. The result is that national long-distance and international call prices continue to be well in excess of costs. Creating more effective competition in the long-distance market will therefore rely on removing the distortions that are currently present in the local call market.

In considering the long-run sustainability of competition it is necessary to make a distinction between national long-distance and international services.

Calling-card and override competition in national long-distance requires, at a minimum, the purchase of a local call or PSTN origination and PSTN termination. It therefore relies on the current access pricing regime and is not sustainably competitive in the long-run.

Calling-card and override competition in the international market, however, may take two forms. In one model the competitor buys PSTN origination and provides a traditional circuit switched call. This will be a high-quality call but will rely on the PSTN access pricing regime and is therefore not sustainably competitive. Alternatively a calling card provider can buy a local call, and use a packet switched (usually VoIP) service to provide the call. The local call can be bought, untimed, from Telstra

⁸² Consumer surveys conducted by the ACA indicate that 8 per cent of households and 13 per cent of small business used a preselect competitor in 2004. See, ACA, *Consumer satisfaction survey 2004*, special report no.14, August 2004, figure 11.

⁸³ *ibid.*

retail. This option therefore does not rely on regulation and will generally be a more sustainable competitive option. It should be noted, however, that the call will be of limited quality due to the current limitations of VoIP technology and will, as noted above, only be a niche competitive constraint. While this option will no doubt offer a sustainable constraint on the market, the constraint is not sufficient for the ACCC to currently consider this market to be sustainably competitive in the long-run.

More sustainable competition in these markets will rely on uptake of ULL by full service operators and the build out of appropriate voice networks by competitive carriers. These options will also give competitors greater access to the underlying costs of provision. This is an essential next step because ACCC analysis indicates that Telstra's profits in these markets are in excess of the already high profits indicated by the most recent imputation testing. These high margins also indicate that while reasonably competitive, the long-distance markets are subsidising local telecommunications. These issues will be discussed further in the final section of this report.

2.4.11 State of competition in fixed-to-mobile

It is not possible to be as positive about the state of competition in the FTM market. As recently discussed in the ACCC's mobile service review, the ACCC does not believe that the FTM market is effectively competitive.⁸⁴ There are several additional difficulties with competition in this market.

While override and calling card competition is possible in the fixed-to-mobile market, it is less likely for a number of reasons. First, FTM does not easily allow for the use of low-cost VoIP technologies. Second, entry to this market is more costly than that of STD and international because the entrant must contract with all four mobile service providers to provide termination, as well as relying on Telstra PSTN origination. Contracting costs may therefore be quite high. Third, the current mobile network operators enjoy a significant cost advantage to provide mobile termination. The ACCC estimates that current mobile termination access charges are well in excess of underlying costs.⁸⁵ Therefore, while a competitive entrant will have to pay the high termination charges, the incumbent operators face lower costs. This leads to the potential for a price squeeze perpetrated by the dominant players.⁸⁶

These constraints lead the ACCC to believe that override and calling-card competition are less effective in the FTM market and that competitors are limited to full-service or preselect competition. As the problems of full service and preselect competition are also present in this market, the ACCC concludes that the market is not yet effectively competitive. This conclusion is supported by ACCC estimates, which indicate that the average retail price in the fixed-to-mobile market is at least double the underlying cost of the service.⁸⁷ Telstra's *Annual report 2004* states that its average yield per customer was 37.8 cents per minute. The ACCC estimates that average residential yield across Telstra, Optus, APPT and Primus is in the order of 46.3 cents per minute. These yields are substantially above the ACCC's estimates of the underlying costs of mobile calls based on international comparisons.

⁸⁴ ACCC, *Mobile services review: mobile terminating access service*, June 2004, pp. 99–108. The present report contains only a brief analysis; more detail is contained in the mobile service review.

⁸⁵ *ibid.*

⁸⁶ The ACCC has received several complaints to this effect. Such activity is more likely in the corporate market where pricing is the subject of a contract and therefore not as easily scrutinised.

⁸⁷ ACCC, *Mobile services review: mobile terminating access service*, final decision, June 2004, p. 102.

A possible conclusion from this analysis is that the currently high mobile termination charges act to exclude potential entrants and also as a focal point allowing existing operators to push up retail prices.

There are, however, signs that, while the market is not yet competitive, there may be some increase in competition. This year's price changes report again shows a modest decrease in FTM prices of 2.2 per cent, continuing the slow downward trend seen over the past five years. As with other services, however, this overall price decrease hides price increases for residential and small business consumers (0.1 per cent and 1.4 per cent respectively).

The ACCC's recent decision on mobile termination charges—which suggest that prices should fall from 21 to 12 cents per minute by January 2007—should provide significant scope for further price decreases and also remove some of the barriers to entry in the FTM market. However, while the decision provides significant scope for increases in competition, it will take some time before the market will be effectively competitive.⁸⁸

2.5 Mobile telecommunications

There is significantly more scope for facilities-based competition in the mobiles market. Four competitors—Telstra, Optus, Vodafone and Hutchison—currently own mobile networks and operate both on a retail and wholesale level. Competition in this market therefore relies less on regulatory intervention and is likely to be more sustainable in the long run. There is, however, still considerable potential for less than competitive outcomes in this market.

There are broadly three competitive models open to operators in the mobile market. They may become carriage service providers (CSPs) making use of their own network to provide retail mobile services. They may choose to resell the carriage services of a CSP or they may become a mobile virtual network operator by reselling the services of an existing network carrier but setting up a technical support layer that replicates the mobile network carrier's mobile switching centre. The market is currently dominated by Telstra, Optus, Vodafone and Hutchison, with other resellers providing only around 10 per cent of mobile services. Consequently, this discussion is predominantly concerned with issues relating to CSPs.

In the recent mobile services review, the ACCC indicated that there were high margins still available in the retail mobiles market, in some cases, up to 40 per cent.⁸⁹ These high margins may indicate that the market is not competitive or may indicate that the market has not yet matured and that consumers are still willing to pay a 'mobility premium'. On one hand, all major carriers continue to show revenue increases in the market. Both Optus and Vodafone show increasing average revenue per user (ARPU) and, although Telstra shows a decreasing ARPU it tends to report increasing margins. These points indicate that there may be cause for scepticism about the competitive character of the market. On the other hand, mobile prices fell by 3.2 per cent this financial year, reversing the price increase that was seen in 2002–03 and financial analysts tend to forecast a more competitive future in the mobile market.

88 The ACCC can only enforce its pricing decisions through its arbitration powers, several of which were notified in late 2004. Also, both Vodafone and Optus have submitted undertakings at significantly higher rates than those recommended by the ACCC. Any decision by the ACCC to reject such undertakings is appealable to the Australian Competition Tribunal.

89 ACCC, *Mobile services review: mobile terminating access service*, final decision, June 2004, p. 95. Here a margin is defined as the ratio of EBITDA to cost.

It is clear, however, that with Optus and Telstra having a combined market share of over 80 per cent, there is potential for less than competitive outcomes—an observation highlighted by the increased market shares of Optus and Telstra over this year.⁹⁰ Given the complexities of the market it is difficult to reach conclusive views about the state of competition, the ACCC believes, however, that while the mobile market may be more competitive than the fixed-line market it is unlikely to be effectively competitive as yet.

There are several aspects of the market that have been of concern. The ACCC stated in this report last year that it was concerned that mobile operators may have an incentive to increase termination charges to push up retail prices. This concern has been considered in the mobile services review which recommended the termination price should fall to a price of 12 cents per minute by January 2007. Such a price fall will give greater scope for competitive pricing in both mobile-to-mobile and FTM markets.

The mobile services review also noted that there are significant sunk costs faced by a potential facilities-based competitor in the mobile market. The need for a prospective retail competitor to have access to national geographic coverage, to build sufficient infrastructure and to gain access to spectrum, all act as barriers to entry which allow the continued high levels of market concentration. That there are significant barriers to entry is highlighted by the recent decisions of the largest players to enter the 3G market on the basis of joint ventures. In this context, while mobile infrastructure is scalable to some extent, the market structure may be one that is naturally oligopolistic. In such a market there will always be concerns that competition is not as fierce as it may be and the concerns related to mobile termination may be one symptom of this. This, however, does not necessarily indicate the need for ongoing and intrusive regulation. It may be the case that the costs of this regulation outweigh the potential benefits.

The ACCC also notes that the growth of 3G mobile services has been a major development in 2003–04 and will be even more significant in coming years. This development poses both opportunities and challenges for competition. At one level, the growth of 3G offers a host of new value-added services to consumers, provides a strong new competitor to 2G networks in the form of Hutchison and also increases the likelihood that mobile communications will act as a constraint on both fixed-line (voice) telecommunications and internet and data services. In this context, the ACCC believes that the growth shown by Hutchison in 2003–04—reported by the ACA to be the fastest in the industry⁹¹—indicates that 3G is likely to become a viable competitive alternative. This growth in 3G will be facilitated by the ACCC's acceptance of the recent network-sharing agreements between Hutchison and Telstra and Optus and Vodafone, which will facilitate 3G services by all current 2G providers in competition with Hutchison.

However, 3G also creates potential for growth in market power through the control of content services. As was evident with pay television, 3G relies to a great extent on the availability of compelling content to make full use of its high bandwidth and justify its premium pricing. Should individual competitors be able to fully control the availability of certain content, it is possible that they will wield substantial market power.⁹² The potential for this kind of market domination is raised

90 ACA, *Telecommunications performance report 2003–2004*, December 2004, p. 70. Telstra's market share increased from 45.8 to 46.5 per cent while Optus's market share increased from 34 to 34.5 per cent.

91 *ibid.*

92 This is of particular concern when the content displays some form of natural monopoly such as the content rights associated with premium sports and entertainment services.

when there is an integrated provider that supplies both 3G, broadband and pay television. Clearly, it is possible to monopolise a particular piece of content across all three of these media. The potential for anti-competitive use of exclusive content will depend on whether there are significant switching costs associated with using more than one network, the availability of both demand-side and supply-side substitutes for the content and whether the content is valued by a sufficient portion of the market. Using these criteria, the ACCC considers that there are only a small number of services that pose difficulties; limited perhaps to major sporting events. More generally, however, while bundling of products will usually be pro-competitive and yield consumer benefits, there may be scope to use bundles to extend market power and the ACCC will continue monitoring this development particularly in the 3G market.⁹³

Finally, the ACCC cautiously welcomes the introduction of 'bucket plans'. In this report last year the ACCC noted that there were 700 mobile plans available in the market. Bucket plans, which allow for the purchase of a group of calls at a set price,⁹⁴ allow for easier comparison both within and across firms and therefore greater consumer control of their purchases. The ACCC sees that these plans may lead to a fall in the average price paid for mobile services in the coming financial year but also notes that there is a potential that consumers will buy plans they don't need, pushing up average spend per consumer. The push for greater consumer sovereignty indicated by these types of plans can also be seen in the growth of pre-paid mobile plans in 2003–04. The ACA reports that pre-paid grew much faster than post-paid and attributes this to consumers' wish to have more control over their monthly expenditure.⁹⁵

2.6 Internet and data services

Broadly speaking, data and internet services achieve data transfer (text, still images, video, voice and high-quality sound) from one location to another. A variety of technologies can be used to deliver these services to business and residential consumers, but with varying speed and reliability.

They include ISDN, frame relay, ATM, leased lines, ADSL, HFC and optical fibre cable, microwave and satellite. These technologies often rely on fixed-line access and transmission services as key inputs.

Data services are primarily supplied to, and used by, large corporate businesses. These include ISDN, frame relay and ATM services as well as data and leased lines. To date the ACCC has received few complaints from industry or business about the competitive supply of these services. None of the complaints received has raised competition concerns. However, as directed by the minister, the ACCC is undertaking more comprehensive corporate market monitoring under the accounting separation regime.

93 For more information on the competitive effects of bundling see ACCC, 'Bundling in telecommunications markets', an ACCC information paper, August 2003.

94 The first of these plans was introduced by Hutchison which sold a bucket of \$500 worth of services on its three networks for \$99.

95 ACA, *Telecommunications performance report 2003–2004*, December 2004, p. 73.

Internet services are supplied to a wide range of consumers, such as large corporate businesses, small to medium enterprises and residential consumers. These include narrowband dial-up internet services supplied over the fixed-line network (primarily used by residential consumers and small businesses) as well as high-speed internet services commonly referred to as 'broadband' which can be supplied using DSL (over the fixed-line network), HFC, microwave or satellite technology. Internet services are supplied to consumers by a large number of internet service providers (ISPs), the number of which increased from 667 providers in September 2003 to 694 in March 2004.

Broadband uptake has been the growth area of telecommunications in this financial year. The number of broadband users increased from 516 800 in 2002–03 to 1 047 800 in 2003–04, a 102 per cent increase.⁹⁶ In addition to being an important market in its own right offering a plethora of benefits to Australian consumers and business, the importance of broadband to the broader telecommunications market should not be underestimated. As noted above, consumers tend to display a status quo bias, resisting changes in their consumption habits barring major disruptions—this bias strengthens the market position of the incumbent. The decision to take up broadband plays an important role in combating the bias. Consumers that decide to investigate a broadband connection are likely to take that opportunity to reassess all of their telecommunications purchases; especially in a market where there is competitive bundling.

In this context, it is not surprising that there has been very aggressive pricing in the market for broadband. In February 2004 Telstra introduced new retail plans for ADSL broadband well below market rates at the time. This aggressive move, while leading to a progressive fall in broadband prices, made it very difficult for access seekers to compete with Telstra. The ACCC consequently issued a competition notice under Part XIC of the Trade Practices Act. The ACCC believes that it is important that access seekers be able to use broadband in order to make a competitive impact in the market. The pricing practices observed in the broadband market in 2003–04 are clear evidence that the market is not sufficiently competitive.

That said there seems to be significant potential for competition in the market. Telstra stated in its *Annual report* of 2004 that it continues to lose market share in both dial-up and broadband markets. Telstra estimates its 30 June 2004 dial-up market share to be 26 per cent down from 27 per cent the year before, while as at 30 June 2004 it had 42 per cent of the broadband market down from 62 per cent on 30 June 2002. This fall in market share is despite Telstra's aggressive pricing and highlights the competitive outcomes that may be available with more reasonable pricing.

Related to the wholesale ADSL market, the ACCC continues to believe that the ULLS and LSS services have the potential to create a more competitive market for internet access. In 2004 the ACCC considered, and rejected, undertakings for both these services. The ACCC is therefore concerned that the services are not being provided in a manner which allows them to facilitate greater competition in the broadband market. This position is supported by Telstra's most recent imputation tests which show that it is difficult for an access seeker to earn a positive margin when taking the ULLS. Although it seems that the negative margin is related more closely to other costs incurred in ULLS take up, rather than the access price previously considered by the ACCC.⁹⁷ This indicates that other

96 ACCC, *Snapshot of broadband deployment as at 30 June 2004*, November 2004. In post-reporting period, broadband numbers increased to over 1.3 million in the September quarter 2004.

97 On the importance of non-price inputs in ULL-based competition see the discussion under ULLS competition above.

provisioning aspects of the ULLS need greater attention and the ACCC has recently been focusing on these aspects. The ACCC also notes that an effective business case for the take-up of ULLS and LSS requires a competitor to first build up a base of customers, which it supplies by reselling Telstra's wholesale services. Anti-competitive pricing of ADSL services may jeopardise this take up and growth in ULLS and LSS and has therefore been a particular focus of the ACCC's enforcement efforts over this period.

In related developments, the ACCC commenced an inquiry into whether or not an internet interconnection service should be declared in April 2003. The ACCC's decision to commence this inquiry was motivated by a concern that the market for internet interconnection may contain structural features that are best dealt with in a long-term sense using Part XIC of the Act. The ACCC continues to have concerns that current practices in internet interconnection give rise to market power and reduce the level of competition in the market. However, given the lack of empirical information, the ACCC issued a final decision indicating that it would not declare the service, but rather issue a record keeping rule (RKR) which will provide the necessary factual information to monitor the market and to make a better informed assessment of market power. The ACCC's decision was motivated by a wish to avoid overbearing regulation.

The markets for internet services are changing, with significant recent changes in broadband pricing in particular. As such, it would be premature to form a view as to whether or not these markets are competitive. However, the ACCC notes that the current reliance on Telstra's wholesale market to provide broadband may not be 'sustainably' competitive. This fact was highlighted by the need for a competition notice in this market in 2004.

2.7 Regulatory approaches to increasing competition

The above discussion presents both positive and negative aspects of current competition. Moving past this point, there are two areas in which gains may be had. First, the continued strengthening of the current access-based regime will allow greater competition at the access/wholesale level and continue to produce competitive outcomes. A by-product of this is continued increase in market share for competitive entrants, and a potentially easier transition to facilities-based competition. Second, significant steps are needed to remove the barriers to competition further up the value chain and to encourage facilities-based competition. As the discussion below highlights, these goals are substantially complementary in the short to medium term, but may be in conflict in the long term.

The ACCC believes that there is greater potential in the second option, although not discounting the benefits that can be gained from the first. While the ACCC will pursue both options within the current regulatory regime, further development may, however, be greatly accelerated if certain key changes are made. The ACCC sees these steps as necessary to provide the sustainable competition that will allow the eventual removal of telecommunications-specific regulation.

2.7.1 Strengthening access-based competition

A necessary first step toward strong access competition is appropriate access pricing. The negative effects of high access pricing have been felt particularly in the FTM market and local call market. In FTM the implications have been exacerbated by the fact that both Optus and Telstra face lower costs than the current termination rates. Equally, the fact that access pricing does not allow competitive entry for a local call-only competitor has proved a significant barrier to entry with effects across all fixed-line services.

Remedying these difficulties, the ACCC released its final determination for the mobile termination access service (MTAS) this year that is intended to promote competition in FTM services. A comprehensive review of local call pricing in early 2005 is also intended to address similar concerns about local call pricing.

The ongoing difficulties in accurately pricing these services relates to the need for cheap access to local call service, asymmetric information and the high costs of effectively modelling incumbent costs. These difficulties are inherent in any access pricing regime and show the limitations of continued reliance on the system. Difficulties with the access regime further strengthen the case for active promotion of facilities-based competition and the slow removal of access regulation. The ACCC believes that the current access pricing decisions relating to MTAS and PSTN and forthcoming review of local call pricing will provide a continued spring board for competition in the short to medium term.

Appropriate pricing of LCS, MTAS and PSTN is also a first step toward breaking down entry barriers in the local call and preselect markets. As MTAS pricing falls, there will be increased potential for effective competition in the FTM market. Similarly, allowing for competition in the local call market alone will potentially remove the ability of Telstra to extract a preselect penalty and encourage entry in both the local-call market and the long-distance and FTM markets. Other initiatives can also minimise barriers to entry in the fixed-line markets.

The cost of switching providers is a problem that can be addressed from various directions. The UK regulator, Ofcom, has placed significant emphasis on consumer information in encouraging switching.⁹⁸ It canvasses several options including: encouraging market participants to provide more accurate and easily understood information; providing pricing comparisons itself; actively encouraging switching by alerting consumers to the benefits of switching; and requiring that operators inform customers of the most advantageous plans given their current consumption. All these options have the potential to increase switching and allow for more rapid growth of newer firms. They are also likely to serve the broader social purpose of ensuring that consumers reap all the benefits of the current levels of competition.⁹⁹

⁹⁸ See Ofcom, *Strategic review of telecommunications: phase 2 consultation document*, 18 November 2004.

⁹⁹ This suggestion may seem overly paternalistic. The approach, however, is largely benign. In the case that consumers are on the wrong plan it will encourage them to switch and allow them to save money. For consumers who are on the right plan, however, it will have no impact. This has been termed, asymmetric regulation, and a useful discussion can be found in Colin Camerer, Samuel Issacharoff, George Loewenstein, Ted O'Donoghue and Matthew Rabin, (2003) 'Regulation for conservatives: behavioural economics and the case for "asymmetric paternalism,"' *University of Pennsylvania Law Review*, 151, pp.1211–54.

To an extent, the current push toward pre-paid and bucket plans reduces the informational complexity of telecommunications consumption. The ACCC will, however, continue to monitor its role in this area but notes that, while market monitoring and information gathering are within its current powers, the more active strategies suggested above would require regulatory change.

This report also argues that the difficulties of switching costs are exacerbated by aggressive pricing by the incumbent. This problem was discussed in the context of Telstra's ADSL pricing. This kind of aggressive pricing, aimed at maintaining market share, can be a significant deterrent to the growth of sustainable competition in many markets. The ACCC attempts to control this pricing through the use of Part XIB of the Trade Practices Act. While this regime is an effective tool against a large scale abuse of market power, it is perhaps not well suited to the more subtle anti-competitive strategies that are available in the current telecommunications market.

The ACCC also hopes to work directly with industry to make more effective use of Part XIB. This involves coming to agreement on the appropriate form of imputation testing and key performance indicators and implementing a strategy for more proactive use of these tools. An essential first step in this process is that Telstra agrees to provide the ACCC with pricing information before its implementation in the retail market. These measures will go some way toward more effective and timely use of the Part XIB framework. In this context, the ACCC notes that imputation testing is currently used by some overseas regulators as a competitive safeguard to protect against anti-competitive pricing in telecommunications markets. For example, the Canadian Radio-television and Telecommunications Commission (CRTC) has prescribed an imputation test for retail local exchange services. This test requires large incumbent carriers to demonstrate that the revenues from a retail service will equal or exceed the sum of the costs of the services according to an established formula. The ACCC will look at similar approaches in Australia. That said the incentive for Telstra and other market participants to engage in such a cooperative approach must be considered and may reduce the effectiveness of the procedure.

The ability for Telstra to provide access products that are of lower quality has been highlighted as a potential deterrent to competitive entry as a full service provider and also as a ULLS-based competitor. Reducing the potential for Telstra to engage in this kind of activity will strengthen the influx of competition to these markets. As noted above, the current system, based on the standard access obligations (SAOs), requires that Telstra provide declared products on a non-discriminatory basis. The more effective implementation of these requirements will be a focus for the ACCC in the short to medium term.

Difficulties in implementing the SAOs and Part XIB could also be resolved using a model that seeks to realign Telstra's interests more closely with those of the end users. Such an approach could involve an extension of the current accounting separation model to create a more effective 'operational separation' of Telstra. This would mean that Telstra's wholesale division would physically supply access to Telstra's retail division, allowing for a much simpler overview and enforcement of the current SAOs. Such a system could also ensure that Telstra's wholesale division does not have the incentive to provide inferior or more costly products to its competitors. Implementation of more effective monitoring and compliance incentives through a model of operational separation also offers significant potential for the growth of facilities-based competition. In this context, the OECD recently commented that the current accounting separation was a 'weak measure' and that,

...the Competition Act should be strengthened by demanding legal separation of network and retail if the benefits of separation would exceed the costs.¹⁰⁰

The ACCC, however, recognises that operational separation will not be in place in the immediate future. In the near term the ACCC will therefore place considerable emphasis on ensuring timely and effective access to the essential elements of Telstra's infrastructure. This will involve more intensive consideration of non-price issues than in previous years.

2.7.2 Transition to facilities-based competition

The measures discussed above are all aimed at allowing efficient entrants to build up market share and to get more direct access to the underlying services that Telstra provides to itself. While these actions will support the access regime, they are also the same actions that over time will help to foster the transition to facilities-based competition.

However, growth in facilities-based competition may, at some point, conflict with the access regime. This report has stressed that the ACCC believes that the future of the industry is best served by the removal of regulation and that this can be achieved when competition moves to a more long-term sustainable level. This outcome may, however, be discouraged if competitors become overly reliant on the access pricing regime. An option which is open to the ACCC, and which will be the subject of more consideration in the future, is the gradual removal of access pricing regardless of competitive outcomes. Such an approach would mean setting a sunset date for access pricing. Any competitor that has not moved to a facilities-based model by that time will no longer be able to benefit.

¹⁰⁰ OECD, *Economics surveys: Australia*, December 2004, p. 110. The ACCC assumes that the 'Competition Act' refers to the *Trade Practices Act 1974* (Cwlth).

3 **Anti-competitive conduct provisions**

This section examines activities undertaken by the ACCC in 2003–04 in relation to the telecommunications-specific and general anti-competitive provisions of the Act.

Part XIB of the Act comprises telecommunications-specific anti-competitive conduct provisions. These provisions prohibit a carrier or carriage service provider (CSP) from engaging in anti-competitive conduct—a prohibition known as the competition rule. Section 151AJ sets out the two circumstances under which a carrier or a CSP contravenes the competition rule.

The first circumstance is when a carrier or CSP takes advantage of a substantial degree of power in a telecommunications market with the effect, or likely effect, of substantially lessening competition in that, or any other, telecommunications market. An examination of the purpose of the conduct is not required under the competition rule—unlike the general s. 46 misuse of market power provisions.

The second circumstance is when a carrier or CSP engages in conduct relating to a telecommunications market that contravenes the general anti-competitive conduct provisions in Part IV of the Act, in particular:

- s. 45—contracts, arrangements or understandings that restrict dealings or affect competition
- s. 45B—covenants affecting competition
- s. 46—misuse of market power
- s. 47—exclusive dealing
- s. 48—resale price maintenance.

3.1 Investigations conducted in 2003–04

During 2003–04 the ACCC conducted nine investigations into anti-competitive conduct, including the following:

- alleged anti-competitive conduct in relation to the wholesale and retail pricing of broadband internet services (see 3.1.3)
- carriers introducing new retail products to the market before or without making them available to their wholesale customers
- alleged anti-competitive conduct in the corporate sector of the telecommunications market, with a focus on an alleged price-squeeze regarding fixed-to-mobile services
- alleged anti-competitive conduct in the dial-up residential internet sector of the telecommunications market in relation to the supply of ISDN internet access

- alleged anti-competitive conduct by a supplier of wholesale broadband services in relation to providing broadband services to customers of competing suppliers.

Four investigations were concluded in the 2003–04 financial year.

3.1.1 Competition and advisory notices

The ACCC may issue competition notices in response to alleged anti-competitive conduct. When exercising this discretion it must consider the guidelines it has issued under s. 151AP(2) of the Act and any other matters it considers relevant.

There are two different types of competition notices:

- Part A competition notice—which may be issued by the ACCC when it believes that a carrier or CSP has engaged, or is engaging, in anti-competitive conduct. It does not constitute prima facie evidence of the matters in the notice. If the carrier or CSP does not comply with the notice, the ACCC may choose to seek orders for pecuniary penalties in relation to the period during which the notice was in force of up to \$10 million and \$1 million per day that the conduct continues.
- Part B competition notice—which the ACCC can issue to help prove a contravention of the competition rule. The Part B competition notice states that a specified carrier or CSP has contravened, or is contravening, the competition rule and sets out particulars of the breach. Once issued, a Part B competition notice is prima facie evidence of the matters set out in the notice (i.e. the facts comprising the particulars of the contravention) in any proceedings under Part XIB.

The ACCC may also issue a notice advising a carrier or CSP of the action that it should take, or consider taking, to ensure that it does not engage, or continue to engage, in anti-competitive conduct.

3.1.2 Competition notice guidelines

In February 2004 the ACCC launched new guidelines on its use of competition notices to tackle anti-competitive conduct in telecommunications markets.

The guidelines set out the matters the ACCC will consider when deciding whether to issue a competition notice during investigations of anti-competitive conduct. The new guidelines followed a public consultation process in December 2003 and replaced the previous guidelines issued in August 1999.

3.1.3 Telstra BigPond broadband competition notice

In February 2004 the ACCC initiated an investigation into Telstra’s wholesale and retail pricing of broadband internet services after receiving a large number of complaints that Telstra’s retail prices were below the costs of supplying retail services, including Telstra’s wholesale rates for broadband services. The ACCC was concerned that the inability to compete, especially at the important entry level end of the market, could ultimately foreclose more sustainable access-based competition at a vital stage of broadband growth in Australia.

In February 2004 the ACCC issued Telstra with an advisory notice while it continued to investigate whether Telstra had breached the Act. In the notice the ACCC advised Telstra to reduce its wholesale prices to a level below its retail prices that would allow Telstra's wholesale customers to provide retail broadband services at prices which do not substantially hinder or prevent them from competing with Telstra.

In March 2004 the ACCC issued Telstra with a Part A competition notice, having formed reason to believe that Telstra had engaged, or was engaging, in at least one instance of anti-competitive conduct.

Shortly after the ACCC issued the competition notice Telstra announced a revised wholesale pricing structure. The evidence obtained by the ACCC suggests that Telstra's wholesale pricing, notwithstanding the revised wholesale pricing, still has significant limitations and that these are likely to substantially hinder the ability of its wholesale customers to compete with Telstra BigPond at the retail level.

Since the ACCC issued the competition notice, there have been several developments which include Telstra revising its wholesale pricing and negotiating with wholesale customers. The most recent revision was notified to the ACCC to take effect from 1 January 2005.

At the time of writing the ACCC was determining whether or not it should revoke the competition notice. The ACCC is assessing the full impact of wholesale pricing changes on the level of competition among internet service providers to determine whether or not it has reason to believe that Telstra is currently engaging in anti-competitive conduct.

3.2 Exemption orders

A carrier or CSP proposing to engage in conduct that may normally breach the competition rule can apply to the ACCC for an exemption order. The ACCC may grant an exemption order if it is satisfied that:

- the resulting public benefit outweighs any public detriment of lessened competition or
- the conduct will not breach the competition rule.

Conduct subject to an exemption order will not be anti-competitive for the purpose of the competition rule.

The ACCC has never received an application for a competition rule exemption.

3.3 Third line force notifications

Third line forcing is a specific form of exclusive dealing and prohibited under ss. 46(6) and (7) of the Act. Businesses may seek immunity from court action under the notification and authorisation process in the Act.

Under the notification processes, immunity from court action for third line forcing conduct is obtained automatically 14 days after lodgement and continues unless and until the ACCC issues a notice removing the immunity.

The ACCC may remove immunity if it is satisfied that the likely benefit to the public would not outweigh the likely detriment of the proposed conduct.

3.3.1 Digital third line force notification

Telstra Corporation and Telstra Pay TV Pty Ltd (Telstra) notified its intention to bundle Foxtel and Austar's digital pay TV services with Telstra's telecommunications services in two separate notifications—submitted in February and April 2004.

On balance, the ACCC considered that the notified conduct would result in a net public benefit as it would provide some customers with discounted or bonus telecommunications services. The ACCC decided therefore to maintain Telstra's immunity for the conduct identified in the notifications.

However, while there may be increased scope for competition between Telstra and firms in telecommunications markets in the short term, the effect of Telstra's bundling of these services in the long term is less clear. Accordingly, the ACCC will continue to monitor the effects of Telstra's bundling conduct on competition (see 5.2.6).

3.3.2 Retransmission notification

In August 2003 Foxtel notified the ACCC of its intention to resupply free-to-air channels in its subscription television packages to both its cable and satellite subscribers when it commences a digital broadcast. In offering this resupply service to free-to-air broadcasters, Foxtel would require these broadcasters to acquire satellite capacity from Optus.

On balance, the ACCC found that there appears to be some public benefit arising from retransmission and from the conduct itself to the extent that it promotes more retransmission. It was not clear that the notified conduct would result in any detriment to the public. The ACCC therefore decided not to revoke the immunity regarding the notified conduct.

3.4 Information papers

3.4.1 Bundling

In August 2003 the ACCC issued the final version of its information paper on the bundling of services in the telecommunications industry. Bundling refers to the combined supply of two or more telecommunications services. The paper sets out the proposed approach the ACCC is likely to follow when assessing whether bundling conduct in the telecommunications industry is anti-competitive. It also outlines the information-gathering powers that the ACCC can use to monitor bundling behaviour.

4 Consumer safeguard provisions

This section details major ACCC investigations involving potential telecommunications breaches of the consumer protection provisions in Part V of the Act. The Act does not have consumer protections specific to the telecommunications market.

A total of 4464 consumer protection complaints regarding the telecommunications industry were registered with the ACCC in 2003–04. This compared to 4247 in the previous financial year.

Of the complaints received, 32 per cent did not fall within the ACCC's jurisdiction.

Each complaint received does not necessarily represent a single issue. Usually there are a number of key issues per year that generate the majority of complaints and therefore several hundred complaints may relate to one issue.

Many of the issues identified were resolved through initial ACCC investigations or by initial ACCC contact with the relevant parties.

There was a significant increase in the number of investigations conducted this year, with 29 investigations undertaken, including the matters outlined below.

4.1 Optus Mobile bait advertising

In May 2003 Optus Mobile advertised a Nokia 7250 camera phone on a \$55 per month plan in a national advertising campaign in various media. Optus Mobile advertised that the offer was available for all of May 2003.

The ACCC's investigation revealed that Optus Mobile did not have sufficient stock to meet customer demand for the 7250 handset during the entire promotion.

In June 2004 Optus provided court enforceable undertakings to the ACCC that it will, among other things:

- refund affected customers
- run corrective advertising
- refrain from advertising handsets when there are reasonable grounds for believing it will not be able to meet reasonable demand
- strengthen its trade practices compliance program.

4.2 Telstra \$0 mobile phone advertising

In August 2003 the ACCC instituted proceedings against Telstra in relation to its \$0 mobile phone advertising in various media in June 2003. The matter was heard in the Federal Court in February 2004. The ACCC alleged that representations made in Telstra advertisements were misleading as customers who signed up to Telstra's \$0 'phone option' did not receive call credits that were available to other customers on Telstra's monthly member plans, and customers had to commit to a longer term minimum contract term, which involved higher early termination charges.

Judgment was delivered in July 2004 when the Federal Court found Telstra's use of \$0 mobile phone advertising misleading and deceptive. Justice Gyles upheld some of the ACCC's concerns and found that the use of \$0 by Telstra was misleading in some respects, as Telstra effectively charged more for \$0 phone packages than it did for the other items in the package without the handset.

4.3 Telstra 'T-Time rewards options' advertising

In May 2004 the ACCC expressed concern to Telstra about its 'T-Time rewards options' advertising. The ACCC was of the view that representations made in a TV advertisement were likely to mislead consumers as material conditions and sufficient information about the offer were not disclosed.

Telstra agreed to:

- stop broadcasting the advertisement
- run a commercial clarifying the features, terms and conditions of the offer
- contact customers who called the number in the commercial and signed up to the offer.

4.4 National Telecoms Group

In February 2003 the ACCC commenced legal proceedings against the National Telecoms Group (NTG) alleging that it had made misrepresentations about the price, benefits and call rates of its packages of services, including its 'Synergy' package.

In December 2003 the Federal Court declared that NTG had:

- engaged in misleading and deceptive conduct when offering its 'Synergy' telephony package
- made false and misleading representations with respect to the price of its telephony services.

The court granted injunctions restraining NTG from making the same or similar representations to consumers in the future. NTG has provided court enforceable undertakings to the ACCC to resolve complaints it had received from customers and to review its trade practices compliance program.

4.5 Global Pre-Paid Communications and In-Touch Networks

In March 2003 the ACCC commenced legal proceedings in the Federal Court against Global Pre-Paid Communications and In Touch Networks and associated individuals regarding the sale of telephone card vending machine distributorships and Swisscom easyRoam SIM card distributorships. The ACCC alleged that misrepresentations were made regarding the profitability, location support and maintenance of vending machines and the nature of the Swisscom business opportunity.

The matter is currently in litigation.

4.6 Unilateral variation clauses

In 2003 the ACCC conducted investigations into unilateral changes by Telstra to its:

- BigPond broadband residential internet plans (from 2001 to March 2002)
- Communic8 pre-paid mobile phone service.

Following these investigations Telstra developed a policy relating to the implementation of changes to the terms and conditions of contracts for consumer and small business products.

The ACCC is concerned about the use of unilateral variation clauses in telecommunications contracts, particularly where service providers rely on such clauses to impose changes to terms and conditions that are detrimental to consumers.

The ACCC has raised its concerns with a number of other service providers and has encouraged service providers to develop methods for complying with the Act.

5 Tariff filing, record keeping, monitoring and reporting

In addition to its general powers to obtain information under s. 155, the ACCC has telecommunications-specific information-gathering powers under Part XIB. These powers, including tariff filing provisions and the power to make record keeping rules, allow it to monitor the pricing conduct of carriers and CSPs when there are concerns about anti-competitive conduct, or when determining appropriate access prices.

They also enable the ACCC to monitor market behaviour in the telecommunications industry and develop appropriate regulatory responses. The Minister for Communications, Information Technology and the Arts can also require that the ACCC monitor and report on various aspects of competition within the industry.

5.1 Tariff filing

The ACCC's tariff filing powers can be divided into two distinct parts:

- general telecommunications tariff filing (Division 4, Part XIB)
- Telstra-specific tariff filing (Division 5, Part XIB).

5.1.1 Tariff filing directions under Division 4, Part XIB

If the ACCC is satisfied that a carrier or CSP has a substantial degree of market power in a telecommunications market, it may direct them under Division 4, Part XIB to provide information on charges for specified carriage services and/or ancillary goods and services or information on its intentions regarding those goods or services.

In 2003–04 the ACCC did not find it necessary to use these powers.

5.1.2 Tariff filing by Telstra under Division 5, Part XIB

Division 5, Part XIB requires Telstra to give the ACCC a written statement setting out any proposed pricing changes for basic carriage services (BCSs) seven days before the change occurs. BCSs are services that allow for communication between two or more distinct places, supplied by fixed line or satellite-based facilities, but not including supply of customer equipment.

A strict interpretation of Division 5 would require Telstra to provide complete details of all offerings, both standard and individualised (non-standard), along with all variations. To reduce the administrative burden of this requirement on both the ACCC and Telstra, the ACCC and Telstra agreed in June 1998 that relevant information would be provided only for those BCSs that were identified by the ACCC as assisting it in detecting potential anti-competitive behaviour.

The agreement consists of the following:

- Telstra is to provide its standard form of agreement on a weekly basis, along with a list of all amendments (additions, variations and withdrawals) that have taken place during that week
- Telstra is to provide a monthly summary report of any non-standard form of agreements that it entered into for that calendar month
- Telstra is to brief the ACCC if it has introduced, varied or withdrawn an offering for a BCS and considers that change to be significant
- The ACCC may also request a briefing to obtain information about any amendments to Telstra's standard form of agreement or about a non-standard form of agreement.

Exemptions exist for particular BCSs when:

- there is a limited likelihood for anti-competitive conduct
- information is already available to the ACCC through the access regime
- information is otherwise available from the previous tariff filing agreement between Telstra and Austel.

During 2003–04 Telstra complied with the requirements to give the ACCC tariff filing information.

5.2 Record keeping rules

Under s. 151BU of Part XIB of the Act, the ACCC has the power to make a record keeping rule (RKR) by written instrument and require that carriers and CSPs comply with it. The rules may specify what records are kept, how reports are prepared and when these reports are to be provided. The ACCC cannot require the keeping of records unless they contain information relevant to its responsibilities.

5.2.1 Accounting separation

In December 2002 the government made provision for an enhanced accounting separation of Telstra's wholesale and retail operations with the passage of the *Telecommunications Competition Act 2002*. In accordance with this Act, the minister issued a direction on 19 June 2003, instructing the ACCC to issue RKRs requiring Telstra to provide the ACCC with reports on:

- current costs in addition to historical costs under the Telecommunications Industry Accounting Framework (CCA reports)
- imputation analysis comparing Telstra's retail prices and the costs faced by access seekers in buying core telecommunications services (fixed network originating and terminating access, wholesale local calls and the unconditioned local loop service) from Telstra (imputation reports)
- key performance indicators on non-price terms and conditions that compare Telstra's customer service performance between specified retail and wholesale supplied services (NPTC reports).

The ACCC issued three RKR during 2004 in consultation with Telstra and the industry more broadly. These replaced the 'initial' RKRs issued during 2003 which had been framed to accommodate what could be readily achieved using existing Telstra data and information systems.

It is a requirement of the direction that the reports be made available to the public.

In 2003–04 the ACA published CCA, imputation and NPTC reports. The ACCC reports six-monthly on CCA, and quarterly on imputation and NPTC.

The direction also requires the ACCC to provide the minister with a six-monthly report on competition in the corporate customer segment of the telecommunications market. This report is subject to a separate process (see 5.3.1).

5.2.2 Regulatory accounting framework

In 2001 the ACCC introduced the telecommunications regulatory accounting framework (RAF), a vertical and horizontal accounting separation model that requires revenue and cost information for wholesale and retail services to be reported to the ACCC. The RAF also requires that service usage information, such as the number of local calls and the number of national long-distance minutes be reported.

In October 2003 the ACCC amended the RAF to improve the robustness and transparency of the reports. The changes related to the notification required by the ACCC for changes to the RAF reports, the audit requirements and auditor standards for audit reports and the treatment of related entities for reporting under the RKR.

5.2.3 Public disclosure of market indicator data

The ACCC commenced publishing extracts of the RAF data in market indicator reports. The published information includes revenues, usage and market share information on a range of retail and wholesale telecommunications services. This information was released in accordance with the approach detailed in the ACCC's disclosure report for RKR information, issued in January 2003.

Disclosure notices regarding the publication of this information were sent to carriers in July 2003 and April 2004. The ACCC released a market indicator report for the 2001–02 period in September 2003, and a report for the 2002–03 period in June 2004.

5.2.4 Internet interconnection record keeping rule

In July 2004 the ACCC issued a RKR to several ISPs and content providers seeking information to assess the effects of internet interconnection arrangements on competition in telecommunications markets.

The RKR required the ISPs and content providers to provide detailed information about their internet networks, customer bases, contractual arrangements, and revenues and costs from providing retail and wholesale internet services. The RKR supported the inquiry into whether to declare an internet interconnection service (see 6.1.5).

5.2.5 ULLS record keeping rules

In December 2001 the ACCC issued two non-financial RKR to Telstra regarding the unbundled local loop service (ULLS). The first requires Telstra to give detailed information on how it provides its competitors with access to its copper network, and the second requires information about deployment and fault handling of ADSL services. During 2003–04 the ACCC continued to monitor Telstra’s conduct in providing service to ULLS access seekers.

5.2.6 Bundling record keeping rule

In March 2003 the ACCC issued a RKR to Telstra seeking information on the effects of bundling on competition in telecommunications markets, and requiring Telstra to provide detailed information about its Rewards and HomeLine residential packages.

The RKR requires Telstra to provide quarterly reports on its bundled service products, including information on matters such as the number of customers receiving, and the total discount given for each bundled offering. During 2003–04 the ACCC continued to monitor Telstra’s bundling conduct.

5.3 Monitoring and reporting

5.3.1 Corporate competition report

The ministerial direction on accounting separation (see 5.2.1) requires the ACCC to monitor and prepare six-monthly reports on competition in the telecommunications industry in the corporate segment of the business customer group.

The ACCC submitted the first report, covering the July to December 2003 period, to the minister on 2 July 2004. The report was tabled in parliament on 2 December 2004.

The first report was principally aimed at delineating the corporate customer segment and outlining the analytical framework the ACCC would employ in assessing the effectiveness of competition for future reports. It discussed competition issues raised with the ACCC by industry, and outlined the ACCC’s proposed approach for gathering further information required for future reports.

5.3.2 Broadband competition monitoring

Division 12A of Part XIB of the Act enables the minister to require the ACCC to provide quarterly reports about competition within the telecommunications industry.

In May 2002 the minister issued *Monitoring and reporting on competition in the telecommunications industry determination 2003 (no. 1)*, which requires the ACCC to provide a quarterly report to the minister on matters relating to competition in broadband services.

Following difficulties encountered with the implementation of the determination, including significant industry compliance costs, the ACCC has been working with the Department of Communications, Information Technology and the Arts to develop an effective broadband take-up monitoring regime. In the meantime, the ACCC has continued to release its quarterly *Snapshot of broadband deployment*, which provides aggregated data on the deployment of broadband services in Australia, disaggregated by technology type. The ACCC will continue to release this report until an expanded monitoring framework is implemented.

5.3.3 Infrastructure report

In October 2003 the ACCC issued *Telecommunications infrastructure in Australia 2002*. The report, which was based on survey responses from 52 carriers operating in the Australian market during 2001–02, details the stock of telecommunications infrastructure as at 30 June 2002.

6 Access to telecommunications network services

This section outlines how the ACCC regulates access to telecommunications networks, including the declaration of telecommunications services, the arbitration of access disputes and the development of pricing principles for particular services.

Part XIC of the Act establishes the industry-specific access regime for the telecommunications industry. The primary objective of Part XIC is to promote the long-term interests of end users (LTIE), which is determined by assessing whether an action is likely to achieve the objectives of:

- promoting competition in telecommunications markets
- achieving any-to-any connectivity (i.e. ensuring communication between users of different networks)
- encouraging the economically efficient use of, and investment in, infrastructure.

The Part XIC access regime only applies to services that are declared. Declaration is the process of determining whether a service should be brought within the regulatory net. Services are declared after the ACCC holds a public inquiry.

A number of services supplied under pre-existing access agreements were deemed to be declared on commencement of Part XIC on 1 July 1997. The ACCC had previously assessed that declaration of these services was in the LTIE.

Once a service is declared, the access provider is subject to standard access obligations (SAOs), which require them to provide the service, on request, to the access seeker. In doing so, the access provider must take all reasonable steps to ensure that the technical and operational quality of the service is equivalent to the service it provides to itself.

While the terms and conditions of access are not specified in the Act, it does provide three ways in which they can be determined:

- by commercial negotiation between the access provider and access seeker
- if commercial negotiations cannot result in an agreed outcome, the ACCC, following notification of a dispute, can determine the access terms and conditions in an arbitration between the access seeker and provider of the declared service
- the ACCC can accept an undertaking by the access provider, which will determine the terms and conditions of access.

The ACCC has previously encouraged industry participants to negotiate and settle their own disputes and will continue to do so.

6.1 Public inquiries into the declaration of telecommunications services

The ACCC's guide, *Telecommunications services—declaration provisions*, explains its approach to particular declaration issues, including the matters that it must consider and how it will consider them. The guide also contains a section dealing with procedural issues, such as the public inquiry process.

6.1.1 Mobile terminating access service inquiry

In March 2003 the ACCC commenced its review of the mobile terminating access service (MTAS) as part of its broad ranging review of mobile services. The MTAS is a wholesale input, used by providers of calls from fixed-line and mobile networks to complete calls to mobile subscribers connected to other networks.

In June 2004 the ACCC released its final decision to issue a new declaration, continuing the regulation of the MTAS services on GSM and CDMA networks, and extending MTAS regulation to include 2.5 and 3G networks.

In reaching its decision the ACCC found that MTAS providers have control over an essential input to the provision of fixed-to-mobile (FTM) and mobile-to-mobile (MTM) calls. Mobile network operators also have both the ability and the incentive to raise the price of the MTAS above its underlying cost. This view was supported by market observations that mobile operators appeared to be setting MTAS charges that were likely to be at least double the underlying cost of provision.

The ACCC considered that above-cost MTAS charges allowed vertically integrated fixed and mobile network operators to raise the cost of rival FTM service providers that only operate fixed-line networks. It also had concerns that this cross-subsidisation pricing structure was likely to create distortions to efficient investment decisions by vertically integrated, mobile and fixed-line only operators.

In releasing its final decision on the MTAS, the ACCC also issued new pricing principles and price-related terms and conditions for the service (see 6.5.1).

6.1.2 Mobile originating access service inquiry

In March 2003 the ACCC commenced its inquiry into whether or not it should extend the existing mobile originating access service (MOAS) declaration beyond its expiry date of 30 June 2004. The existing MOAS declaration was limited to a sub-group of calls made from mobile phones to 13/1300 and 1800 numbers.

In June 2004 the ACCC released its final decision that the declaration applying to the MOAS should be allowed to expire.

In reaching this view the ACCC noted that, when mobile operators provide originating access to calls made by their subscribers as an input for providers of calls to 13/1300 and 1800 numbers,

it would appear these operators have control over access to all subscribers making such calls from their networks. However, during the course of its inquiry, no evidence was provided to the ACCC to suggest that mobile operators were denying access to origination of calls to these numbers on their networks, or setting excessively high prices for these services. Because of this, it was not clear to the ACCC that continued declaration of an MOAS would promote the LTIE of telecommunications services.

6.1.3 Mobile domestic inter-carrier roaming inquiry

In March 2003 the ACCC commenced its inquiry into whether or not it should declare domestic inter-carrier mobile roaming as part of its broad ranging review of mobile services. Mobile domestic inter-carrier roaming is a wholesale service that enables mobile subscribers to make and receive calls by means of another network in Australia when outside the coverage of the network to which they subscribe.

In December 2004 the ACCC released its final decision not to declare the service.

In the draft decision the ACCC noted that a number of roaming agreements have been commercially negotiated by operators since it first considered whether to declare this service in 1997–98. Further, at the time of the draft decision, there had been no recent complaints to the ACCC about the terms and conditions for domestic mobile roaming services.

However, given concerns regarding structural features in the markets in which domestic mobile roaming services are supplied, the ACCC intends to continue to monitor the situation via an RKR.

6.1.4 Mobile international inter-carrier roaming report

In March 2003 the ACCC commenced its consideration of international inter-carrier mobile roaming as part of its broad ranging review of mobile services. International inter-carrier roaming is a wholesale service that enables mobile phone users to make and receive calls when travelling in overseas jurisdictions.

Consideration of this issue was prompted by a number of complaints from consumers about what they considered to be high prices for mobile calls when travelling overseas. During the review, the ACCC has asked interested parties to comment on whether some form of regulation for international roaming services would be appropriate, and if so, what form this regulation should take.

The ACCC's report will be released in the 2004–05 financial year.

6.1.5 Internet interconnection declaration inquiry

In April 2003 the ACCC commenced an inquiry into whether or not an internet interconnection service should be declared, issuing a discussion paper. Internet interconnection is the manner in which internet service providers (ISPs) connect to each other's backbone networks and transfer internet traffic between each other.

In January 2005 the ACCC issued its final decision not to declare the service as:

- while interconnection is an essential feature of providing internet services, there does not appear to be a bottleneck associated with the supply of interconnection services
- the ACCC does not have sufficient information at this time to determine whether declaration of an internet service would be in the long-term interests of end users (LTIE).

The draft decision also sought comments on whether internet interconnection arrangements should be subject to a two-year period of monitoring under an RKR.

6.1.6 Transmission capacity service declaration review

In September 2003 the ACCC commenced a review of the transmission capacity service declaration ahead of the expiry date of the declaration at the end of March 2004. Transmission capacity is a wholesale high bandwidth service (greater than 2 Mbps) used for the carriage of voice, data or other communications between points located throughout Australia. The ACCC regulates access to this service over a range of capital–regional city routes.

A final decision was made in March 2004 to exclude 14 capital–regional city routes from the declaration where there is effective competition or evidence of sufficient contestability to promote the competitive provisions of these services. The ACCC also discontinued its inter-capital transmission monitoring program as there is now sustained competition on all inter-capital routes.

6.2 Exemption from declaration

The SAOs require, among other things, that an access provider supply a declared service to an access seeker if requested. Under s. 152AT of the Act, a carrier or CSP may apply to the ACCC for a written order exempting it from the SAOs that apply to a declared service.

If the ACCC believes that an order made regarding an application for an exemption is likely to have a material effect on the interests of a person, the ACCC must publish the application and invite submissions on whether the application should be accepted.

The Act also enables an access provider (or a potential access provider) to apply for and receive an exemption from the SAOs before an investment in a service is made or that service becomes an active declared service.

The ACCC must not grant an exemption order unless it is satisfied that the making of the order will promote the LTIE.

6.2.1 Digital pay TV exemption

In March 2002 Foxtel and Optus announced their intention to enter into a content supply arrangement in relation to pay TV programs. The ACCC concluded then that, if given effect, the arrangement would breach the competition provisions of the Act. To address these concerns, various parties provided the ACCC with undertakings in November 2002 under s. 87B of the Act. These processes are described in detail in the ACCC *2002–03 Telecommunications competitive safeguards* report.

The s. 87B undertakings included commitments to put in place a third party access regime for digital pay TV services.

In December 2002 Telstra and Foxtel applied to the ACCC for anticipatory individual exemptions from SAOs in relation to the then proposed supply of digital pay TV services. The applications provided for a separate access regime for third parties to use Telstra's digitised cable and Foxtel's digital set top units (STUs).

In December 2003 the ACCC granted the exemptions subject to a number of limitations and conditions, including that Telstra and Foxtel further strengthen the terms and conditions of access outlined in the November 2003 access undertakings.

The decisions to grant the exemptions were appealed to the Australian Competition Tribunal in December 2003 by the Seven Network and C7. In September 2004 the tribunal announced that it had upheld this application and that the decision to grant the exemptions be set aside.

6.3 Access undertakings

Part XIC includes a mechanism allowing access providers to give voluntary access undertakings on the supply of declared services. Undertakings must set out the terms and conditions under which the access provider undertakes to comply with the particular SAOs.

Under Part XIC the ACCC is required to accept or reject an undertaking. If accepted, the ACCC must apply a relevant undertaking in an access dispute. For that reason, if accepted by the ACCC, undertakings provide a degree of certainty to both access providers and access seekers.

In assessing access undertakings, the ACCC is required to satisfy itself that:

- the undertaking is consistent with the SAOs outlined in the Act
- the terms and conditions of access are 'reasonable', as defined in the Act.

6.3.1 Telstra and Foxtel pay TV analogue access undertakings

As part of the 2002 s. 87B undertakings arising from the Foxtel-Optus content sharing deal (see 6.2.1), Foxtel and Telstra Multimedia (TMM) undertook to provide third parties with access to Foxtel's analogue set top units (STUs) and Telstra's cable under separate Part XIC access undertakings.

TMM and Foxtel subsequently submitted the Part XIC access undertakings in November 2002. These undertakings were rejected by the ACCC in December 2003, largely because of concerns with the proposed access charge for Foxtel's STUs and with some of the non-price elements of both undertakings.

In December 2003 TMM and Foxtel lodged revised Part XIC access undertakings that sought to address the concerns identified. The revised access undertakings were subsequently accepted by the ACCC in March 2004.

6.3.2 Core service undertakings

In November 2003 Telstra lodged revised undertakings for the core services, specifying the terms and conditions under which it would meet its SAOs to supply the domestic public switched telephone network (PSTN) originating and terminating access services, the unbundled local loop service (ULLS) and the local carriage services (LCS) for 2002–03, 2003–04 and 2004–05.

- The PSTN originating and terminating service is used by access seekers primarily to supply long-distance, fixed-to-mobile and mobile-to-fixed calls. It is also used by other network operators to interconnect with Telstra's network.
- The ULLS involves the use of the copper 'line' between customers and the local exchange. The service enables access seekers to supply high-speed data services, such as ADSL, as well as local and long-distance voice services.
- The LCS is a service for the carriage of calls from one customer to another customer within the same standard zone. It allows access seekers to provide local calls on a resale or wholesale basis in competition with Telstra.

The lodgment of the revised undertakings followed the withdrawal of previous Telstra undertakings lodged in January 2003. The previous undertakings were withdrawn following the release of the final ACCC determination on the model terms and conditions of access for the core services in October 2003 (see 6.5.2).

The ACCC released its draft decision regarding the revised core service undertakings in October 2004. In its draft decision the ACCC proposed to accept the undertakings for the PSTN and the LCS and to reject the undertakings for the ULLS. Following the draft decision Telstra withdrew its ULLS undertaking and submitted a revised undertaking for this service in December 2004.

In December 2004 the ACCC accepted Telstra's undertakings for the PSTN and the LCS.

6.3.3 Line sharing service undertaking

In September 2003 Telstra lodged an access undertaking specifying the terms and conditions under which it would meet its SAOs to supply the line sharing service (LSS).

The LSS is a service that enables two carriers to provide separate services over a single metallic pair or 'line'. It allows Telstra to supply basic telephone services to a consumer while also enabling its competitors to provide high-speed broadband data services, such as ADSL, to the customer on the same line.

In August 2004 the ACCC released its final decision to reject the LSS undertaking, largely because it considered the price terms and conditions were not reasonable. The ACCC concluded that a charge closer to \$7–\$9 per service would be more reflective of efficient costs than the \$15 charge proposed by Telstra.

Telstra subsequently lodged a revised LSS undertaking in December 2004.

6.4 Access disputes

As part of the ACCC's role in regulating access in the telecommunications industry, it has arbitration powers enabling it to issue directions, conduct hearings and make determinations to resolve access disputes. The ACCC must undertake arbitrations if notified of an access dispute, but only after private negotiations, mediation and/or conciliation fail. When the ACCC accepts a relevant access undertaking, the terms of the undertaking must be applied in resolving the dispute. If there is no undertaking relevant to the dispute, then the ACCC may determine the appropriate terms and conditions within the arbitration process.

Before a dispute is referred to the ACCC for arbitration, the following criteria must be satisfied:

- a declared service is supplied, or will be supplied, by a carrier or a CSP
- one or more SAOs apply, or will apply, to the carrier or CSP in relation to the declared service
- an access seeker is unable to agree with the carrier or CSP about the terms and conditions on which the carrier or CSP is to comply with those obligations.

6.4.1 Dispute resolution guidelines

In March 2004 the ACCC released a revised *Resolution of telecommunications access disputes—a guide*. The guide is intended to serve as a handbook for both practitioners and the industry explaining how the ACCC uses its powers under both the *Trade Practices Act 1974* and the *Telecommunications Act 1997* to resolve telecommunications access disputes.

The release of the revised guide followed an industry consultation process regarding changes effected by the *Telecommunications Competition Act 2002*.

6.4.2 Arbitrations

The ACCC has not received a new arbitration since March 2001. There were two continuing arbitrations in 2003–04, both relating to analogue pay TV services.

TARBS and C7 first notified the ACCC of disputes regarding access to Telstra's cable in 1999 and 2000 respectively. The arbitrations were initially delayed due to various Federal Court proceedings. Interim determinations were subsequently issued in April 2001. However, access seekers did not implement the determinations before April 2002, causing the interim determinations to lapse. The focus of the arbitrations then shifted to resolving issues ahead of making final determinations.

In a related process, Telstra and Foxtel lodged Part XIC undertakings with the ACCC relating to analogue pay TV services in November 2002 (see 6.3.1). As a result, the pay TV arbitrations were put on hold while the ACCC considered these arrangements. While the November 2002 undertakings were rejected by the ACCC in December 2003, revised undertakings submitted by the parties in December 2003 were subsequently accepted by the ACCC in March 2004.

As the revised undertakings effectively established the terms and conditions of access under which third parties could use the declared analogue pay TV service, both TARBS and C7 withdrew their dispute notifications in June 2004.

6.5 Pricing principles and indicative pricing

Following the declaration of a service, it has often been ACCC practice to develop and release pricing principles to inform the market of its likely decisions in arbitrations and so provide greater certainty to access seekers and promoting the timely resolution of access disputes without having to refer them to the ACCC.

Changes to the legislation in December 2002 required that pricing principles be issued for each newly declared service.

6.5.1 Pricing principle for the mobile terminating access service

In releasing its decision to continue the regulation of the mobile terminating access service (MTAS) in June 2003 (see 6.1.1), the ACCC issued new pricing principles and price-related terms and conditions for the service.

The ACCC's monitoring of the previous GSM retail benchmarking pricing principle led it to believe that a more direct mechanism was needed to generate a closer association of the price and the underlying cost of production. In this regard, the ACCC determined that the total service long run incremental cost, adjusted to include contributions to common costs (TSLRIC+), is the appropriate measure of costs towards which the price of the MTAS should trend.

In price-related terms and conditions issued with the determination, the ACCC indicated that the price should fall to 12 cents per minute by January 2007, commencing with an immediate reduction to 21 cents per minute on 1 July 2004 and continuing with three further reductions of three cents per minute on 1 January in each of the following three years.

The ACCC estimated the TSLRIC+ by using reasonable cost estimates available to it at the time of the decision. These included cost models developed in overseas jurisdictions and accounting information provided by Australian mobile carriers.

In July 2004 Vodafone sought Federal Court review of the ACCC's pricing principle under the *Administrative Decisions (Judicial Review) Act 1977*. The matter had not been heard substantively at the time of writing.

6.5.2 Model terms and conditions for core services

Section 152 AQB of the Act required that the ACCC publish model terms and conditions relating to access to core services—defined as the domestic public switched telephone network (PSTN) originating and terminating access services, the unbundled local loop service (ULLS) and the local carriage services (LCS). For a description of these services see 6.3.2.

The ACCC released its final determination on price and non-price terms and conditions in October 2003. This specified lower access charges for use of Telstra’s fixed network over the next three years.

The model terms and conditions are not binding, but provide guidance on the ACCC’s views on fair terms and conditions of access to these core telecommunications services.

6.5.3 Pricing principles for non-geographic number portability

In October 2003 the ACCC issued pricing principles for the non-geographic number portability (NGNP). Non-geographic numbers are used to provide freephone (1800), local rate (13/1300) and premium rate (1900) services.

The pricing principles specify that the ACCC, if required to arbitrate a dispute over the terms and conditions of the provision of NGNPs will, in the usual case, allocate the costs between the donor CSP and the recipient CSP.

6.5.4 Pricing principles for transmission capacity service

In June 2004 the ACCC issued a draft guide outlining the pricing principles it will generally apply when assessing arbitrations and undertakings for the transmission capacity service (see 6.1.6). In the draft guide, the ACCC indicated that it will likely use a total service long run incremental cost (TSLIRIC) methodology when arbitrating disputes or assessing undertakings for the transmission capacity service.

The final pricing principles, which did not vary from the draft pricing principles, were subsequently issued by the ACCC in September 2004.

6.6 Telecommunications access code

Under s. 152BJ of the Act, the ACCC is empowered to make a Telecommunications Access Code. In 2003–04 the ACCC did not consider that a code was required following the release of the model terms and conditions for the core services in October 2003 (see 6.5.2).

7 Number portability

This section outlines the ACCC's legislative responsibilities and associated activities under the Telecommunications Act regarding number portability for telecommunications services.

Number portability provides end users with the ability to change their service provider within specified number ranges (e.g. the number range used to provide mobile services) and retain the same number.

Division 2, Part 22 of the Telecommunications Act requires the Australian Communications Authority (ACA) to develop a numbering plan outlining the allocation and use of numbers in connection with the supply of carriage services. Under s. 458 of the Telecommunications Act, the ACCC has statutory powers to direct the ACA regarding number portability. The ACA cannot establish rules about number portability in the numbering plan unless the ACCC directs it to do so, and any rules the ACA inserts into the plan must be consistent with ACCC directions.

In 2003–04 the ACCC did not issue any directions to the ACA regarding number portability.

8 Other responsibilities under the Telecommunications Act

8.1 Price control review

Under Division 3, Part 25 of the Telecommunications Act, the ACCC must hold a public inquiry if directed to do so by the minister. In April 2004 the ACCC was directed by the minister to undertake a review of the price control arrangements that apply to Telstra.

The direction required the ACCC to hold a public inquiry about the current price control arrangements that apply to Telstra, and the arrangements that should apply after the expiry of the *Telstra carrier charges—price control arrangements, notifications and disallowance determination no. 1 of 2002* on 30 June 2005.

In June 2004 the ACCC released a discussion paper for the review. The ACCC then consulted extensively with interested parties through written submissions and in 12 public meetings throughout Australia, including metropolitan, regional and remote locations. On 9 November 2004 the ACCC released a draft report and the final report was provided to the minister on 8 February 2005.

8.2 Telstra preselection exemption

In 2003–04 the ACA conducted its ongoing annual review of Telstra’s preselection exemption for the Communic8 pre-paid home service. The Communic8 pre-paid home service is a pre-paid fixed-line service which enables multiple customers to establish pre-paid accounts on the same fixed line. As part of this process, the ACA sought the ACCC’s views under s. 352 of the Telecommunications Act, which places a requirement on the ACA to consult with the ACCC when considering a pre-selection exemption.

On balance, the ACCC considered that the benefits from requiring Telstra to provide pre-selection for their pre-paid home service are outweighed by the infeasibility of the implementation of this requirement, and that the ACA should continue to provide Telstra with an exemption for the Communic8 pre-paid home product.

8.3 Australian Communications Industry Forum (ACIF)

During 2003–04 ACCC staff participated as observers on several code committees organised by ACIF, the industry body for telecommunications companies.

ACIF committees comprise representatives of the telecommunications industry, consumer groups and government regulators (such as the ACCC, the ACA and the Telecommunications Industry Ombudsman).

A number of codes were progressed within ACIF during 2003–04, covering:

- mobile number portability (revision)
- local number portability (revision)
- rights of use—premium calls services
- consumer contracts
- prices, terms and conditions (revision).

The ACCC's involvement in ACIF committees includes consumer protection issues, as well as operational and network issues.

ACIF's Code Administration and Compliance Scheme will continue to monitor compliance of industry participants who are signatories to these codes. If codes are registered with the ACA, it can take enforcement action against industry participants for failure to comply.

8.3.1 Mobile number portability (MNP)

ACCC staff contributed to meetings to review the MNP industry code as well as the related IT specifications and operations manual. The revised industry code and associated documents were finalised in August 2003.

Under the revised MNP code, the losing carrier must meet performance levels of completing 90 per cent of ports within three standard hours of operation, and 99 per cent of ports within two business days. The revised code was registered by the ACA in February 2004.

8.3.2 Local number portability (LNP)

ACCC staff continued to participate in meetings convened by ACIF to review its industry code on LNP, including the IT specifications and operations manual. The revised industry code sets out the procedures that carriers and CSPs must follow to support requirements related to porting telephone numbers associated with many services.

The revised industry code and associated documents were completed in August 2003. The ACA registered the code in November 2003. Following the revision of the code, the working committee continued to meet to discuss outstanding LNP issues.

8.3.3 Rights of use—premium call services

ACCC staff continued to participate in meetings convened by ACIF to develop an industry code on rights of use for premium call services. Once a number of contractual issues have been resolved, it is expected that the code will be finalised. ACIF intends to submit the code for registration by the ACA.

8.3.4 Consumer contracts

In November 2003 the ACA directed ACIF to develop an industry code on consumer contracts. ACCC staff participated in working committee discussions on the draft code during 2004.

The draft code, which was released for public comment in November 2004, specifies rules to determine when consumer contract terms may be considered unfair, including having regard to the intelligibility and accessibility of contract terms that enhance consumer comprehension.

8.3.5 Prices, terms and conditions

In 2003–04 the ACCC continued to participate in the review of the Customer Information on Prices, Terms and Conditions Code (PTC code). The PTC code specifies minimum requirements for suppliers to meet in informing customers about the prices, terms and conditions of goods and services on offer.

The code is being revised to clarify provisions for the presentation of information, the availability and pricing of the product and/or service, bundling of products and comparative advertising. In June 2004 the revised draft code was released for public comment.

8.3.6 Next Generation Networks

ACCC staff also contributed to meetings of ACIF's Next Generation Framework Operations Group (NGN FOG), which was originally tasked with progressing interconnection issues associated with the emergence of NGNs and multimedia services they are intended to deliver. The ACIF FOG submitted its final report *Policy and regulatory considerations for new and emerging services* to the Department of Communications, Information Technology and the Arts in August 2004.

8.4 Other codes

8.4.1 eMarketing Code of Practice

ACCC staff participated in the development of the draft eMarketing Code of Practice. The eMarketing Code of Practice has been developed by the Australian eMarketing Code Development Committee, chaired by the Australian Direct Marketing Association (ADMA), to establish comprehensive industry rules and guidelines for the sending of commercial electronic communications in compliance with the *Spam Act 2003*. It is anticipated that the code will be registered with the ACA by early 2005, making it enforceable.

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