Australian
Competition &
Consumer
Commission

BUNDLING
IN
TELECOMMUNICATIONS MARKETS

An ACCC draft *Information paper*

January 2003

1 Introduction

Bundling of one type or another has been a feature of the telecommunications industry for some time. However, recently there has been a significant increase in the number and range of bundled packages being supplied by carriers or carriage service providers (CSPs). Coinciding with the growth of bundled packages, there have been increasing concerns from both industry participants and consumers in regard to issues of transparency and possible anti-competitive conduct arising from such practices.

The Australian Competition and Consumer Commission (the Commission) has considered the issues associated with bundling in telecommunications during 2002. These considerations extended to work on the issue generally, and particular application in the notifications lodged by Telstra in regard to its third line force conduct to include pay TV services in one of its bundled packages.

The purpose of this draft information paper is to provide carriers, CSPs, and other industry stakeholders (including end-users) with the proposed approach the Commission is likely to follow when assessing whether specific bundling conduct in the telecommunications industry is anti-competitive. In particular, the proposed approach details key factors the Commission will consider in determining whether a carrier or CSP has engaged, or is engaging in, anti-competitive conduct. In this regard, this information paper can be considered supplementary to its existing information paper titled "Anti-competitive conduct in the telecommunications markets".[1]

Accompanying this draft information paper are two reports prepared by National Economic Research Associates (NERA) for the Commission, which the Commission has used to assist it in preparing this report. The first report is on the application of imputation tests to a bundle of services in the telecommunications industry. The second report discusses anti-competitive bundling strategies, focusing on instances where the bundling of a carrier or CSP may cause a reduction in the "addressable market" of its competitors.

The information paper also discusses the Commission's information gathering powers, with specific reference to bundling conduct. These powers enable the Commission to monitor market behaviour within the telecommunications industry, allowing it to develop appropriate regulatory responses. In this regard, these powers are relevant in the context of monitoring of bundling conduct, which can inform the Commission of, and allow it to investigate and evaluate, potential anti-competitive behaviour.

This report is structured as follows:

Chapter 2 provides background on bundling, discusses its wide use in the telecommunications industry, and also details its potential benefits and detriments.

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[1] Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets – Information Paper*, 1999. In particular, an extension of the discussion on bundling found on p. 26.

Chapter 3 provides background on relevant enforcement and information gathering powers of the Commission under the *Trade Practices Act 1974* (the Act).

In Chapter 4, the Commission provides guidance on how it will assess whether particular bundling conduct is anti-competitive. In particular, this chapter focuses on the assessment of a reduction in the addressable market of competitors and possible vertical price squeezes.

In Chapter 5, issues surrounding the further use of information gathering powers to monitor and investigate the conduct detailed in chapter 4, are discussed.

1.1 Making a submission

The Commission invites submissions in response to this draft information paper. The Commission prefers that all submissions be in writing and publicly available to foster an informed, robust and consultative process. Accordingly, submissions will be treated as public documents unless otherwise specified. It is preferred that where industry participants wish to submit confidential information they should provide confidential and non-confidential versions of their submission. In these circumstances, the confidential version will need to highlight any such information.

Submissions should be addressed to:

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Submissions can also be lodged by e-mail to: ken.walliss@accc.gov.au. **Electronic lodgement of submissions is encouraged** in addition to hard copy submission. All submissions are requested by 5pm **Friday 7 February 2003**. Enquiries about this information paper, or about the making of submissions, can be directed to Ken Walliss on (03) 9290 1869 or Elizabeth Carlile on (03) 9290 1953.

2 Background

2.1 What is bundling?

Bundling generally refers to the situation where two or more products or services are sold as a single package.[2] The price of the bundled package is usually at a discount to that of acquiring given amounts of the products separately, and a residential consumer is likely to receive only one bill for all of the services provided in the bundle.[3]

There are various selling strategies for bundling in telecommunications markets. One strategy consists of the products being available either individually or in a package. For example, Telstra's GSM and CDMA mobile telephony services are available on an unbundled basis and also on a bundled basis with (at least) fixed telephony services in its "Rewards Packages".

Another strategy refers to the situation where a product is sold only on a bundled basis. In telecommunications, line rental and local calls generally are not sold as individual services but are only provided together in a bundled package.

A further strategy involves the supply of one service (the tying product) conditional on one or more other services (the tied products) also being supplied. This is commonly referred to as tying. In this case the tying product is only available on a bundled basis. For example, pay TV can only be obtained from Telstra in its "Rewards Packages" if at least fixed telephony services are also acquired.

Bundling can include the services of only one company (a "full line" force), or the services of different companies (a "third line" force). The Act has specific provisions concerning third line forcing, which is a *per se* contravention.

Bundling may also be between telecommunications and non-telecommunications services. It may also be used to create new products. This may be relevant to issues of market definition, and to the assessment of competition issues.[4]

2.2 Current bundling in the industry

Bundling is becoming a growing and important aspect of telecommunications service provision for carriers and CSPs. Retail bundling strategies are usually aimed at

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[2] Most products can be considered a bundle of inputs, depending on the level of specificity. In this paper, the primary focus is on bundling between well-established product categories within telecommunications and related markets, such as national long-distance calls and dial-up internet services.

[3] Services may also be discounted via "introductory" or "special" offers or through waiving otherwise payable charges such as installation or set-up costs.

[4] See Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets – Information Paper*, 1999, pp. 26-27.

specific customer classes – corporate, small to medium enterprises or residential customers. For each customer class, carriers and CSPs appear to have a variety of bundled packages.

A selection of bundled packages for residential customers of the two major carriers, Telstra and Optus, are outlined in Table 1.

Table 1 Overview of bundled packages offered to residential customers by Telstra and Optus

Telstra	Optus
"Telstra Rewards Packages": ▪ Fixed telephony and mobile; ▪ Fixed telephony and internet*; ▪ Fixed telephony and pay TV; or ▪ Fixed telephony plus two or more of: – mobile; – internet*; or – pay TV.	▪ "Choices 1" - Fixed telephony and pay TV ▪ "Choices 2" - Fixed telephony and dial-up internet; ▪ "Choices 3" - Fixed telephony, pay TV and dial-up internet; ▪ "Choices 4" - Fixed telephony and high speed internet; or ▪ "Choices 5" - Fixed telephony, pay TV and high speed internet.

* Almost all of Telstra's dial-up and broadband internet services can be included in the package, however a discount does not apply to ADSL services.

Smaller carriers and CSPs also offer an array of bundled packages, although the number of services offered in the bundle is not always as extensive as those available from Telstra and Optus. For example, Primus offers a discount for a bundle comprising long distance calls, international calls, and internet access when obtained on a single bill.

For retail residential customers, Telstra and Optus cite bundling of services as a major competitive retail growth strategy. For example, Dr Switkowski, Telstra's Chief Executive Officer, said in a speech in March 2001 that: [5]

> Last September, we introduced "true" bundled product offerings to the residential market, where customers receive discounts when they group together their fixed, mobile and internet services. The early results are very pleasing, with nearly half of a million customers signing up in the first three months. These customers are twice as likely to be high value and three to four times as likely to remain loyal to Telstra.

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[5] Ziggy Switkowski, Credit Suisse First Boston Conference, Hong Kong, March 2001. Cited in AAPT's submission to the Commission in relation to Telstra's third line force notification, 4 October 2002, pp. 18-19.

Similarly, Optus reported that its bundling strategy has been very successful, with 81 per cent of new customers to its Consumer and Multimedia division, which offers local telephony, pay TV and high speed internet services over hybrid-fibre coaxial cable, taking more than one product.[6]

2.3 The potential benefits and detriments of bundling

Bundling may have associated benefits or detriments, depending on the specifics of the conduct. These specifics include the extent of market power held by the carrier or CSP providing the bundled services, the types of services being offered in the bundle, the structure of the markets for these services and any price discounts that are offered.[7] Further, while there may be short-term benefits associated with bundling, in some instances, there may be long-term detriment if competition decreases.

Bundling can be beneficial for both consumers and the carrier or CSP supplying the bundled services if it results in significant efficiencies and pro-competitive benefits. Conversely, it can be detrimental for consumers and competitors of the carrier or CSP supplying the bundled services if it is used for anti-competitive purposes or has anti-competitive effects. The overall welfare implications, and the specific impacts on carriers/ CSPs and consumers, vary depending on the nature of the conduct and the structure of the effected markets.

In terms of benefits, bundling can allow carriers or CSPs to exploit economies of scope between bundled goods, and economies of scale if the bundling conduct has significant impacts on consumer demand. Consumers can gain when these benefits are passed on in the form of lower retail prices or quality improvements.

Further, bundling can enable carriers or CSPs to discriminate between the price of services when they are supplied as a part of a bundle and when they are supplied individually. This allows carriers and CSPs to set prices such that profits are maximised and efficiency increased. Price discrimination can be defined as the practice of charging different prices to different consumers, for the same goods, where the price differences do not reflect differences in the cost of supply. Carriers or CSPs can also price discriminate via other means, such as different pricing for different geographical areas, and discounts for "consumer loyalty".

Consumers can also benefit from bundling by being able to receive one bill for many different services, although the extent of this benefit depends on their individual preferences. Benefits may exist in terms of lower transaction costs and the convenience of receiving one bill for several services.

In terms of detriment, bundling may be anti-competitive if it forecloses or reduces competition by enabling the leveraging of market power from one market to another, rather than as a result of greater economic efficiency. In this way bundling may be

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6 Optus, *Annual Report to Shareholders 2001 – Part 2*, p. 24.

7 Services may also be discounted via "introductory" or "special" offers or through waiving otherwise payable charges such as installation or set-up costs.

used strategically to diminish competition or significantly reduce the ability of competitors in a particular market to efficiently compete against a limited number of bundled providers. The pricing of a bundle of services may also raise anti-competitive conduct concerns, particularly if it is predatory or results in a vertical price squeeze. The potential for bundling to be anti-competitive is further discussed in section 4.

3 Legislative Background

This chapter discusses the current provisions in the Act of relevance to bundling conduct. This includes provisions relating to anti-competitive conduct and information gathering powers.

3.1 Enforcement under the Trade Practices Act

Currently, assessment of the effects of bundling can be considered under a number of provisions of the Act. The various provisions have different criteria to evaluate whether the conduct in question constitutes a breach of the Act. In assessing conduct under the anti-competitive conduct provisions, the behaviour may be subject to a test of substantially lessening competition, or a purpose-based test. Otherwise anti-competitive conduct may also be exempted from legal proceedings by the process of an authorisation or notification, which is usually subject to a public-interest based test.

3.1.1 Anti-competitive conduct provisions

The Act sets out anti-competitive conduct provisions relevant to telecommunications in Parts IV and XIB.

Section 45 of the Act prohibits contracts, arrangements or understandings that restrict dealings or affect competition. For example, sub-paragraph 45(2)(a)(ii) states that a corporation shall not make a contract or arrangement, or arrive at an understanding, if a provision of the proposed contract, arrangement or understanding has the purpose, or would have or be likely to have the effect, of substantially lessening competition.

Section 46 proscribes misuse of market power by corporations that have a substantial degree of power in a market. This section prohibits taking advantage of that power for the purpose of eliminating or substantially damaging a competitor, preventing the entry of a person into any market, or deterring or preventing a person from engaging in competitive conduct in any market. The Commission does not have the power to authorise conduct which contravenes or is likely to contravene section 46.

Section 47 of the Act prohibits exclusive dealing. Broadly, exclusive dealing involves one firm which trades with another imposing restrictions on the other's freedom to choose with whom, or in what it deals. For example, sub-sections 47(2) and (3) prohibit "full line forcing", which involves the supply of goods or services on condition that the purchaser does not acquire goods or services from a competitor of the supplier. This conduct must have the purpose, effect or likely effect of substantially lessening competition before a breach of the Act will be made out. "Third line forcing" conduct is not subject to a competition test, and is discussed in section 3.1.3 of this paper.

Section 151AK states that a carrier or CSP must not engage in anti-competitive conduct ("the competition rule"). Under section 151AJ a carrier engages in anti-competitive conduct if it has a substantial degree of market power in a telecommunications markets and it:

- takes advantage of that power with the effect or likely effect of substantially lessening competition in that or any other telecommunications market; or
- engages in conduct in contravention of specified sections of Part IV of the Act, including section 45, 46 or 47 and that conduct relates to a telecommunications market.

In assessing bundling practices under the provisions in Part IV or Part XIB that are subject to a competition test, the Commission's approach would involve assessment of the likely impact on competition in the relevant market(s), guided by considering competition with or without the conduct. This assessment would not explicitly refer to any efficiency criteria, such as the impact on overall welfare (via analysis of consumer and producer surplus).

3.1.2 Authorisation/ notifications/ exemption orders

Under section 88 of the Act the Commission may, upon application, grant an authorisation to a corporation to enter and/or give effect to contracts, arrangements or understandings that fall under section 45, even if they are anti-competitive, so long as the Commission determines there are public benefits outweighing the anti-competitive detriment. While the authorisation remains, the corporation is granted immunity from legal proceedings for conduct that would otherwise breach the Act.

Similarly, section 93 allows a corporation to lodge a notification seeking immunity from the Act for conduct that falls under section 47. Protection can be withdrawn by the Commission if it determines that the conduct is likely to have the effect of substantially lessening competition and that no public benefit is likely to result, or the public benefit is not outweighed by the public detriment constituted by any lessening of competition.

Under section 151AS a carrier may seek an exemption for conduct of the type outlined in section 151AJ. The Commission must not make such an exemption order unless it is satisfied that the conduct will, or is likely to, result in a benefit to the public, and that benefit outweighs the detriment constituted by any lessening of competition. In determining whether these conditions are satisfied, the Commission may have regard to the criteria set out in section 151BC such as, but not limited to, whether the conduct relates to supply to community or charitable organisations.

Whilst the Act does not define what constitutes a public benefit, the Commission and the Australian Competition Tribunal have recognised that, among others, fostering efficiency and the promotion of competition in the industry are public benefits.

Whilst efficiency can be considered as a public benefit for authorisations and notifications, the criteria for exemption orders in telecommunications markets are not explicitly efficiency-based.

3.1.3 Third line force

Sub-sections 47(6) and (7) of the Act prohibit "third line forcing", which involves the supply of goods or services on condition that the purchaser acquire goods or services from a particular third party or a refusal to supply because the purchaser will not agree to that condition.[8] This conduct is a *per se* breach, meaning that the conduct is illegal irrespective of its impact on competition.

Such arrangements may be protected from challenge through the authorisation process or by notification. Under section 93 a corporation may lodge a notification obtaining immunity from legal proceedings under the Act. Protection can be withdrawn by the Commission if it determines that the public benefit of the conduct is not outweighed by the public detriment.

3.2 Information gathering powers

The Commission has specific information gathering powers relevant to performing its functions or exercising its powers under Parts XIB and XIC of the Act (in addition to its general powers to obtain information under section 155). These powers allow it to examine the pricing conduct of carriers and CSPs where there are concerns about anti-competitive conduct, or for use in determining appropriate access prices for declared services.

These powers also enable the Commission to monitor market behaviour within the telecommunications industry, allowing it to develop appropriate regulatory responses. In this regard, these powers are relevant in the context of monitoring of bundling conduct, which can inform the Commission of, and allow it to investigate and evaluate, potential anti-competitive behaviour.

3.2.1 Tariff filing

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

- general telecommunications tariff filing; and
- Telstra-specific tariff filing.

The Commission has general telecommunications tariff filing powers under Division 4 of Part XIB. This allows the Commission to direct a carrier or CSP, with a substantial degree of power in a telecommunications market, to provide it with certain information on charges for specified carriage services and/or ancillary goods or

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[8] The Act distinguishes between conduct known as "third line" and "full line" forcing. In particular the Act prohibits a corporation from forcing the product of another company, even its related company, or offering a discount on that basis (a "third line force"). However, if the same practice was to occur within the one corporate entity, the practice would be considered "full line forcing" and be subjected to a competition test under sub-section 47(2). The conduct would be lawful if it would not result in an adverse effect on competition.

services (including goods or services for use in connection with a carriage service) or information on its intentions regarding those goods or services.

The effect of a tariff filing direction is that carrier or CSP must give the Commission details of its charges for goods or services coming within the direction, and also give details at least seven days in advance of imposing new charges, varying or ceasing to impose those charges for goods or services coming within the direction.

Division 5 of Part XIB requires Telstra to file information for all basic carriage services (BCS) with the Commission. Specifically, Telstra is required to provide the Commission with a written statement setting out its proposed pricing changes for each BCS. Telstra is required to provide this information at least seven days before imposing, varying or ceasing to impose a charge for a BCS.[9]

3.2.2 Record-keeping rules

Section 151BU of Part XIB empowers the Commission to make record-keeping rules (RKRs) by written instrument and require that carriers and CSPs comply with these rules. The rules may specify what records are kept, how reports are prepared and when these reports are provided to the Commission.

The Commission cannot require the keeping of records unless they contain information relevant to the responsibilities of the Commission. For the purposes of section 151BU, these responsibilities include the operation of Parts XIB and XIC.

Sections 151BUA, BUB and BUC of the Act provide for the Commission to disclose record-keeping rule information to the public or to specific persons under certain conditions.

The recent *Telecommunications Competition Act 2002* enables the Minister to direct the Commission to prepare and publish reports using its RKR powers. This is further discussed in section 5.1.

3.2.3 Section 155

The Commission's primary mandatory power to obtain information in relation to enforcement functions is section 155. This enables the Commission to:

- obtain information or documents, or require the answering of questions under a formal examination where is has reason to believe that the relevant information relates to a contravention or possible contravention of the Act, or is relevant to a "designated telecommunications matter" (which includes the performance of a function under Part XIB or XIC); and

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[9] A strict interpretation of Division 5 would require Telstra to provide complete details of all offerings, both standard and individualised (non-standard), along with variations made to these offerings. As this was viewed as administratively burdensome, the Commission and Telstra agreed to a streamlined tariff filing process that met the fundamental objectives of Division 5. This is detailed in *ACCC Telecommunications Reports 2000-01*, 4 March 2002, p. 30.

- enter a person's premises to examine documents to ascertain whether the person has engaged or is engaging in conduct that may contravene the Act.

It is an offence under the Act for a person to fail to comply with a section 155 notice, even if providing information under the notice may incriminate that person for proceedings under the Act (where the person is a body corporate).

4 Bundling and anti-competitive conduct

As noted in section 2.3, bundling can be efficiency enhancing and pro-competitive, or anti-competitive depending on the specifics of the conduct. Section 3.1 outlined the provisions of the Act that proscribe anti-competitive conduct, which may be relevant when considering particular bundling conduct. This chapter provides guidance on how the Commission will assess particular bundling conduct, either in terms of the anti-competitive provisions in Part IV and XIB of the Act or as a part of public interest authorisation/ notification considerations.[10]

It is important to note that the Commission will assess bundling conduct on a case-by-case basis, taking into account the specifics of the bundled package being assessed. In this regard, the particular terms and conditions of the bundled conduct relating to the services being provided, the extent of any discounts and the length of any contract are likely to be relevant considerations.

While the Commission will assess bundling conduct on a case-by-case basis there are two key elements which will form a part of the Commission's anti-competitive conduct or authorisation/ notification considerations. These are:

- whether the bundling conduct significantly reduces the "addressable market" of competing carriers or CSPs, such that equally-efficient competitors are unable to compete on their own merits; and

- whether the price(s) for the bundled services involves predatory pricing or a vertical price squeeze.

In both cases, bundling conduct is only likely to raise anti-competitive conduct concerns when the carrier or CSP has market power in the supply of at least one of the bundled products.[11] Where this is the case, bundling provides a carrier or CSP with the opportunity to leverage its market power from the market(s) in which it has market power into more competitive markets. It may also have competitive impacts in the markets where the carrier or CSP has market power.

4.1 Reduction in the "addressable market"

When a carrier or CSP bundles services and has substantial market power in at least one of the markets for those services the Commission will inquire into whether the "addressable market" of competing carriers and CSPs is significantly reduced. The

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[10] This chapter only considers the competitive implications of the conduct and does not address all elements of a provision that need to be established for breach of the Act, or all relevant matters that may be taken into account when considering such conduct under the authorisation, notification or exemption provisions. In this regard, this chapter only forms one part of the Commission's overall consideration of specific conduct.

[11] The Commission has commented on market power in telecommunications markets in Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets – Information Paper*, August 1999, at pp. 36-39.

addressable market refers to the proportion of consumers in a particular market that are, in effect, available to competitors.

The reason for making such inquiries is that by bundling the service for which it has substantial market power, a carrier may be able to significantly reduce its competitors' addressable markets for the other services in the bundle. This may occur if the carrier has market power and:

- sets prices at levels such that the pricing strongly encourages a significant proportion of consumers to purchase the bundle of services rather than individual services from competing carriers and CSPs;
- only supplies the services for which it has substantial market power within the bundled package, thus "capturing" sales of the other services in the bundle for which it faces competition[12]; or
- faces large one-bill effects that would lead to a significant proportion of consumers only acquiring their services from one carrier.

The first point relates to pricing and may be able to be assessed through the predatory pricing and imputation tests outlined in the following section.

The second point refers to tying. For this strategy to be feasible, the carrier must have sufficient market power in the provision of the tying product to be able to coerce customers into purchasing the bundle.[13] The Commission is likely to consider the extent and nature of competition in markets for the tied and tying products when considering whether bundling conduct reduces the addressable market of competitors.

The third point relates to one-bill effects, which may occur if consumers value the convenience of acquiring all services from one carrier or CSP.

In assessing whether the addressable market for competing carriers and CSPs is significantly reduced, and whether this amounts to a substantial lessening of competition, the Commission may consider *inter alia*:

- the state or likely state of competition in the various markets for the services in the bundle;
- the likely future take-up of the bundled services;[14] and
- whether the segment of the market which is likely to purchase the bundle has particular characteristics (such as high incomes) that will magnify or reduce the impacts on competition.

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12 NERA, *Anticompetitive bundling strategies – A Report for the ACCC*, Sydney, January 2003, p. 1.

13 *Ibid*, p. 11.

14 This may include an assessment of whether the elements of the bundle are strong complements.

It is noted that addressable market effects may be more pronounced in the event that competing carriers and CSPs are not able to supply some services within the bundled package.

4.1.1 Pricing and bundling

The Commission discusses anti-competitive pricing in the *Anti-competitive conduct in telecommunications markets* information paper.[15] In that paper, the Commission notes the pricing conduct that could have the effect of substantially lessening competition included predatory pricing and price squeezes.

This chapter supplements the discussion in that information paper, with particular focus on testing the price of bundled services. In this regard, the commentary below starts by outlining predatory pricing and vertical prices squeezes for single services and then discusses such conduct, and the assessment of such conduct, when services are supplied as a part of a bundled package.

Predatory pricing and vertical price squeezes

Predatory pricing describes situations where a carrier or CSP with substantial market power takes advantage of that power by setting prices below a particular measure of cost which results in it sacrificing short-term profits. Such conduct may involve a corporation taking advantage of its market power for the purpose or effect of substantially damaging or eliminating a competitor, or competitors more generally, or preventing or deterring a firm from engaging in competitive conduct in any market. For example, it may force equally-efficient competitors to exit the market and deter future competitive entry. Alternatively, it may have the purpose or effect of substantially lessening competition.

In contrast, while a vertical price squeeze requires that an integrated carrier possess market power, it is not necessarily the case that losses are incurred. An integrated carrier can achieve a price squeeze by reducing the margin between the retail price it charges in the downstream market and the wholesale access price it charges for an essential input to the downstream service such that an equally-efficient competitor using that input will not be viable. The margin could be reduced by lowering the retail price for a service and/or raising the wholesale access price for an essential input.[16]

As noted in section 2, the supply of bundled services often involves discounted retail prices (as compared to when services are supplied individually). In this context, both predatory pricing and vertical price squeezes may be of concern — predatory pricing for carriers who have their own wholesale access inputs and vertical price squeezes for carriers or CSPs reselling wholesale access inputs. For example, bundling may result in predatory pricing as the prices of services in the bundle may be lowered to

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15 See Australian Competition and Consumer Commission, *Anti-competitive conduct in the telecommunications markets – Information Paper*, August 1999, pp. 43-48.

16 It is noted that even though margins may be reduced, carriers could still make profits if access prices were above long-run costs.

the extent that they do not cover the sum of wholesale and retail costs.[17] Further, it may result in a vertical price squeeze as lower retail prices reduce the margins between retail prices and wholesale access prices.

The question in both cases is whether bundling results in conduct which is anti-competitive. Predatory pricing and imputation tests can assist in making this assessment, although it is noted that these tests, in and of themselves, are not conclusive that conduct is anti-competitive. Rather they will be important diagnostic tools for assisting in determining whether conduct contravenes the Act.

Testing for predatory pricing and vertical price squeezes

As noted, predatory pricing involves a carrier or CSP pricing its product or service below a particular measure of cost such that it sacrifices short term profits. As such, the test involves consideration of the full cost to the carrier or CSP of supplying the product or service. The cost basis for assessment of such conduct is discussed below.

An imputation test can be used to assess whether or not an integrated carrier is engaging in a price squeeze. Unlike a predatory pricing test, which looks at total supply costs, an imputation test takes account of the wholesale access price an integrated carrier or CSP *charges* for the essential input that it supplies to its downstream competitors. An imputation test is designed to determine whether the margin between the price for a wholesale input and the retail price of a downstream service is sufficient to cover the efficient retail costs of the integrated carrier.[18] An imputation test is relevant both for individual services or services supplied as a part of a bundle.

The Commission recently engaged NERA to consider the appropriate way in which to test for anti-competitive price squeezes in the telecommunications industry using imputation tests. NERA's report[19] on this matter details its views as how to conduct imputation tests including in circumstances where services are bundled. It considers that to determine whether a price squeeze is occurring imputation tests should be undertaken with reference to the market in which the conduct is occurring.

This said, NERA also notes that a number of complications can arise when applying imputation tests to bundled packages, particularly where market definition does not coincide with a bundled package. In this regard it considers the application of "aggregate" imputation tests, which sum the relevant price and cost information for all

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17 Retail costs include all costs associated with transforming the essential input into the retail product.

18 There is an increasing amount of literature on the topic of imputation tests and its application to telecommunications industries. Refer King, S. and R. Maddock, "Imputation Rules and a Vertical Price Squeeze", *Australian Business Law Review*, 30, 1, 2002, pp. 43-60 or submissions by Core Research, on behalf of AAPT or Hutchison in relation to Telstra's third line force notification. Copies of these latter reports are available from www.accc.gov.au.

19 NERA, *Imputation tests for bundled services – A report for the Australian Competition and Consumer Commission*, Sydney, January 2003.

services in the bundled package, may not be straightforward. The reasons for these complications include:

- the market of concern may be narrower than the bundle;
- the market of concern will likely include bundled and unbundled supply of services; and
- allowance needs to be made for circumstances where competitors can not supply all services in a bundled package.

NERA provides its views about how to address these complications. Where the market of concern is narrower than the bundled package, it proposes that (price or cost) information relating to the non-relevant services(s) should be removed. This means that information relating to the provision of only the service or service in the relevant market is tested. In instances where it is considered that the market includes bundled and unbundled supply of services, NERA considers that the price and cost information should be weighted to reflect the proportion of bundled and unbundled supply in the relevant market(s).

Further, where competitors can not supply all services in a bundled package NERA proposes a test that imputes the retail price of these services when supplied on an unbundled basis (if observable). This reflects that consumers will have the choice between the integrated carrier or CSP's bundle or the competitor's services and separate purchase of those services competitors cannot supply.

NERA's report also notes that "aggregate" imputation tests have the benefit of allowing for economies of scope and scale (which may occur as a result of bundled service provision) to be more readily incorporated.

The Commission considers that a market-by-market approach to imputation testing is likely to be appropriate, particularly when assessing the impact on competition in defined markets. This said, the Commission acknowledges that complications will occur in applying imputation tests to bundled packages, particularly where market definitions and the bundled packages do not coincide. In this regard, it considers that NERA's proposed approaches will likely overcome such difficulties. The Commission also considers it may be necessary to take into account economies of scope and scale relating to bundled service provision.[20]

Price and cost basis for assessing conduct

An important issue in assessing predatory pricing or price squeezes is whether the test is undertaken on a marginal cost or average total cost basis. As the names suggest, the marginal cost approach considers pricing and costs at the margin to determine whether a price squeeze or predatory pricing is occurring (or has occurred). An

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[20] Where ex post imputation tests are preformed using actual data it is likely these effects will already be captured in the data. For ex ante tests these effects may need to be taken into account when price and cost data are estimated.

average total cost approach considers average prices and costs in making the assessment.

In its report NERA notes that the distinction between the marginal and average total cost based imputation tests can be summarised as follows:

- failing a marginal cost based test would generally be a sufficient, but not necessary, condition for establishing that pricing practices are likely to be anti-competitive; and

- failing an average total cost based test is a necessary condition for establishing that pricing practices are anti-competitive but it is not, on its own, sufficient.

The Commission notes that if a predatory pricing or imputation test based on average total costs is passed, a marginal cost approach would also be passed. In essence, a marginal cost approach sets a higher threshold for establishing that pricing conduct is likely to be anti-competitive than an average total cost test.

NERA's report concludes that marginal revenue and cost based tests are more definitive (compared to average total costs) as to whether pricing practices are likely to be anti-competitive. This said, NERA notes that in practice the revenues and costs being considered would be for the volume of sales the firm would enjoy as a result of the conduct rather than the last unit sold. Therefore, the broader the market definition or longer the time period of the conduct the higher the proportion of total revenues and costs that would be considered marginal.

While having regard to NERA's report, the Commission's view is that when these tests are applied in the context of telecommunications services (including bundled packages) an average total cost basis is likely to be an appropriate starting point.[21] This partly reflects its view that, in industries such as telecommunications, marginal costs are likely to be low and in some cases close to zero. Therefore, while marginal revenues may be above marginal costs, operation at a price below average variable cost means the firm is not even covering its variable costs – which would be inconsistent with what would be observed in a competitive market. In this regard, conducting a test on a marginal cost basis would not necessarily be indicative of whether an equally-efficient provider would be able to remain in the relevant market(s) in the long run. To eliminate this possibility the Commission, like NERA, therefore believes that the marginal cost approach should be qualified to apply only where marginal cost exceeds average variable cost.

This said, pricing below average total cost, is not necessarily indicative of predatory pricing or a price squeeze. Rather, the conduct may be consistent with competitive market behaviour where prices continue to make contributions above the average variable cost of supplying the service and the carrier or CSP is therefore able to recover some of the fixed costs associated with supplying the service. For example, if an entrant builds substantial additional capacity to supply a market, an initial period of

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[21] This is not necessarily inconsistent with NERA's conclusions, particularly where the conduct being considered occurs in a broad market or over a longer timeframe – resulting in a greater proportion of total costs being classified as marginal.

intense competition and below average total cost pricing may follow as the entrant and the incumbent carriers or CSPs strive to utilise their available capacity. The price-cutting will likely cease when the growth in demand for the product or service catches up with the increase in total capacity. In this case, short-term pricing below average total cost is a reflection of intense competition in a product market characterised by economies of scale.

In light of this, and as NERA describes, the Commission considers a "grey area" occurs where pricing conduct fails a predatory pricing or imputation test based on average total costs, but passes based on marginal costs (above average variable costs). For this reason the Commission will likely perform predatory pricing and imputation tests on both qualified marginal cost and an average total cost basis. It will then be able to detect whether the conduct falls inside the "grey area".

In the event that the conduct does fall inside the "grey area", the Commission is likely to consider other factors to assist it in determining whether the conduct is anti-competitive. Some issues which may be relevant to this consideration are listed below.

- Will the pricing have an appreciable effect on existing competitors or new or potential entrants to the market?
- Are the retail price decreases of some substance and duration?
- Are the retail price decreases selective in terms of customers?
- Do past patterns of pricing conduct point to similar levels of pricing? For example, is seasonal pricing or pricing related to the utilisation of infrastructure capacity involved?
- What will be the likely future impact of the bundling conduct on retail prices for the relevant products or services?[22]

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[22] This effectively raises the issue of whether the carrier or CSP will be able to raise the retail prices for the goods to levels above the competitive level. In saying this, the Commission notes Justice Merkel's statements in *Boral* that it is not necessary to establish that the corporation is likely to recoup losses it incurs in order to prove a breach of section 46. See *ACCC v Boral Ltd* (2001) 106 FCR 328; ATPR 41-803 at 42,803. This case is subject to appeal.

5 Information gathering and bundling conduct

In making assessments of potential anti-competitive behaviour or to inform its decisions in relation to authorisation or notifications, the Commission needs access to the right types of information to inform its decision making.

Different types of information are required for different elements of the Commission's consideration. The timing of the provision of information is also relevant.

- Tariff filing information allows the Commission to be informed of changes to the terms and conditions of supply of specified goods or services on an ongoing basis. This information is provided at least seven days in advance of any such changes, making it aware of imminent product charges.

- The Commission's information gathering powers under section 155 may also be relevant to determine whether specific bundling conduct substantially lessens competition in a market or markets.

- Record-keeping rules are a flexible power that enables the Commission to receive information to assist it with:

  - assessing competition in a market or markets;

  - determining access prices for declared services, or undertaking predatory pricing or imputation test analysis; and/or

  - monitoring compliance by a carrier or CSP with a provision of the Act, such as compliance with the standard access obligations for declared services.

As noted, RKRs are a flexible power which allow the Commission to request various types of information for different purposes. In this regard, it is likely to be the most appropriate power for the ongoing collection of specific information, not just tariffs, from carriers or CSPs. This will also allow the Commission to have readily available information that may potentially be relevant to the consideration of whether particular bundling conduct is anti-competitive.

The following section outlines both the current and proposed use of the RKR power, the latter in relation to requiring regular reporting of information relating to bundling to the Commission. It also discusses the potential public disclosure of RKR information.

5.1 Regulatory Accounting Framework

The Commission already receives comprehensive information on costs, revenues and usage from Telstra, Optus, Vodafone, AAPT and Primus under the Telecommunications Industry Regulatory Accounting Framework (RAF) RKR. This RKR requires these carriers to provide financial information to the Commission on a regular basis, allowing the Commission to compare the (historical) unit cost of various services and provide increased transparency to assist in conducting imputation or

predatory pricing tests. The RAF data may form the basis for such a test (although additional information may be required to properly undertake the test), or it may assist in providing a "sanity check" of a predatory pricing or imputation test using different data.

Additionally, Parliament has recently passed the *Telecommunications Competition Act 2002*, which provides the Minister power to direct the Commission in the use of its RKR powers. The Minister has outlined a proposal to extend the accounting separation regime under the RAF, and that some RAF information be released publicly. Importantly, this will include a requirement that the Commission prepares and publishes an imputation analysis (based on Telstra purchasing the "core" interconnect services at the price that it charges external access seekers), to determine whether there is any systemic price squeeze behaviour.

5.2 Other Recording-keeping rules

Notwithstanding the proposed Ministerial direction and the existing RAF information, the Commission is concerned that it has insufficient information to monitor bundling conduct in telecommunications markets that can be used to assist in investigations of specific bundling. It is therefore considering the use of the RKR power to obtain further information from Telstra in regards to its residential bundling conduct.

At this stage, the Commission is only intending to require information from Telstra, given Telstra's market share in telecommunications markets, including basic access services. However, the Commission may consider extending the RKR to other carriers or CSPs where it believes that additional information may assist it in carrying out its functions.

The Commission is likely to request that Telstra provide the following information:

- the total number of customers obtaining each type of bundled offering;
- the total number of new customers obtaining each bundled offering; and
- whether a discount is offered, and if so, the total accrued discount for each bundled offering.

The information will allow the Commission to observe the impact that Telstra's existing bundles have on competition. This will include the impact which bundling pay TV will telephony services is having on relevant markets.

5.3 Potential public disclosure of information

The Commission has the power to require public disclosure of RKR information where it assists in promoting competition and/ or in facilitating the operations of Parts XIB and XIC through enhanced transparency and the benefits of doing so outweigh confidentiality concerns. These objectives may be achieved where RKR information assists carriers or CSPs to identify potential anti-competitive behaviour and thus enable these interested parties to initiate their own action under the Act, or by

assisting the Commission in undertaking its functions and responsibilities under the Act.

As noted above, the Minister has signalled that he will be requiring public release of imputation tests on Telstra's interconnect "core" services. The Commission would also consider public release of other RKR information whether it meets the requirements of the Act.

In this regard, the Commission notes that it released a draft report seeking comment on the Commission's approach to the public disclosure of RKR information in August 2002.[23] The Commission is currently finalising this report.

[23] Australian Competition and Consumer Commission, *Regulatory Principles for the public disclosure of Record Keeping Rule information – a draft report*, August 2002.