



## **Operational separation - Retail pricing protocol**

*An ACCC information paper*

**August 2006**

## **Important note**

*Please note that this information paper is a summary designed to provide basic information on the ACCC's approach to assessing potentially anti-competitive behaviour in telecommunications markets and the ACCC's views on the concept of 'price equivalence' under Part 8 of the Telecommunications Act 1997. This information paper does not cover the whole of the Trade Practices Act 1974 (TPA) and does not exhaustively set out the ways in which the ACCC will determine whether conduct is anti-competitive.*

*Moreover, because this information paper avoids legal language wherever possible there may be some generalisations about the application of the TPA. Some of the provisions referred to have exceptions or important qualifications. In most cases the particular circumstances of the conduct need to be taken into account when determining the application of the TPA to the conduct.*

# 1 Introduction and Background

## 1.1 Purpose of the retail pricing protocol

The purpose of this protocol is to outline the ACCC's role in relation to the pricing aspects of the operational separation of Telstra, and how this role sits alongside its responsibilities under the TPA.

This protocol also provides guidance to Telstra as to how it should demonstrate pricing equivalence for particular designated services. As indicated in Telstra's OSP, the intention is for the ACCC to provide its views on methodological issues for Telstra's consideration in the development of its Retail Pricing Tool. The ACCC will further describe how the imputation tests derived from the Retail Pricing Tool will be broadly interpreted by the ACCC in assessing allegations of vertical price squeezes under Part XIB of the TPA.

The remainder of this protocol is structured as follows:

Section 2 sets out the legislation governing the ACCC's role in ensuring Telstra's compliance with operational separation, including price equivalence.

Section 3 outlines the ACCC's views on which price equivalence imputation tests should be conducted in Telstra's Retail Pricing Tool and the services, markets and customer groups which it understands price equivalence imputation tests are to apply to.

Section 4 sets out the ACCC's views on a number of methodological principles for conducting price equivalence imputation tests.

Section 5 outlines the ACCC's views on what information Telstra should report to it and also to the public in order to achieve transparency and to demonstrate price equivalence.

## 1.2 Background

In April 2005, the Department of Communications, Information Technology and the Arts (DCITA) released an issues paper seeking comments and views from the telecommunications industry and other interested parties about whether it would be appropriate or desirable to make further changes to the telecommunications competition regime.<sup>1</sup>

An outcome of this review was the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, which introduced an 'operational

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<sup>1</sup> DCITA, *Telecommunications Competition Regulation – Issues Paper*, April 2005, page 3

separation' framework for Telstra to support greater equivalence and transparency in Telstra's wholesale and retail operations.

This framework applies to Telstra's 'designated services' which have been specified as:

- Wholesale ADSL (Layer 2);
- Domestic PSTN Originating Access Service;
- Domestic PSTN Terminating Access Service;
- Unconditioned Local Loop Service;
- Local Carriage Service;
- Line Sharing Service; and
- Domestic Transmission Capacity Service.<sup>2</sup>

The Government specified that one of the fundamental aims of operational separation is 'to provide transparency that Telstra is not favouring its own retail activities over the activities of its wholesale customers, while allowing Telstra to obtain legitimate benefits from vertical integration.'<sup>3</sup> This has been expressed more simply as the concept of 'equivalence'.

A key aspect of 'equivalence' is equivalent pricing. The Ministerial Determination *Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1)* outlined that the concept of 'equivalent' pricing would be addressed through the establishment of a Price Equivalence Framework (PEF). The Government has sought such a Framework to provide ongoing assurance to the market that Telstra is not favouring its retail business units by implicitly supplying services to itself at prices which are unjustifiably lower than those offered to downstream competitors.

The implementation of the operational separation of Telstra is primarily the Minister's responsibility. The *Telecommunications Act 1997* requires Telstra to prepare and give to the Minister for approval a draft operational separation plan which must be directed towards the achievement of the aim and objectives of operational separation. This plan must contain provisions requiring Telstra to establish and comply with a PEF relating to designated services.<sup>4</sup>

The Ministerial Determination *Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1)* outlines the objectives of Telstra's PEF:

- public assurance that Telstra is behaving legitimately in the pricing of relevant eligible services supplied to customers of a retail business unit, when compared

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<sup>2</sup> Telecommunications (Operational Separation – Designated Services) Determination (No. 1) 2005, 'Schedule – Active declared services determined as designated services'.

<sup>3</sup> Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, page 82

<sup>4</sup> Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005, Clause 13

with the prices at which Telstra provides designated services to wholesale customers;

- increased certainty for Telstra that its pricing decisions do not contravene Part XIB of the TPA; and
- improved information for the ACCC in performance of its functions under Part XIB of the TPA.<sup>5</sup>

To facilitate the development of the principles surrounding price equivalence, the Government established a working group comprised of the ACCC, DCITA and Telstra (with an expert facilitator).<sup>6</sup>

Telstra submitted its Draft Operational Separation Plan (OSP) to the Minister on 3 April 2006. The Draft OSP provided, amongst other things, that by 30 June 2006, Telstra would establish a PEF relating to designated services aimed at achieving the outcomes outlined above.

The Minister approved Telstra's OSP on 23 June 2006.

Telstra released its Price Equivalence Framework Strategy<sup>7</sup> on 30 June 2006.

The model of operational separation set out in Part 8 of the *Telecommunications Act 1997* requires Telstra to operationally separate its wholesale business unit and key network business units from its retail business units. This model does not require Telstra to maintain separated accounting systems.

As outlined in the Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005* the ACCC had previously proposed a model of operational separation that would require internal arm's length dealings between Telstra's retail business and its wholesale business.<sup>8</sup> Such a model would not require any regulatory involvement in price setting and would ensure transactions between Telstra's internal business units could be compared with Telstra's dealing with its wholesale customers.

However, the decision not to require separate accounting systems has resulted in a different regulatory model for establishing and assessing Internal Wholesale Prices (IWPs) and price equivalence. The PEF and this Retail Pricing Protocol are outcomes of the model of operational separation which has been legislated by Government.

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<sup>5</sup> Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005, Clause 13

<sup>6</sup> Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, page 15

<sup>7</sup> The strategy can be found at: [http://telstrawholesale.com/custsupp/performance\\_separation.cfm](http://telstrawholesale.com/custsupp/performance_separation.cfm)

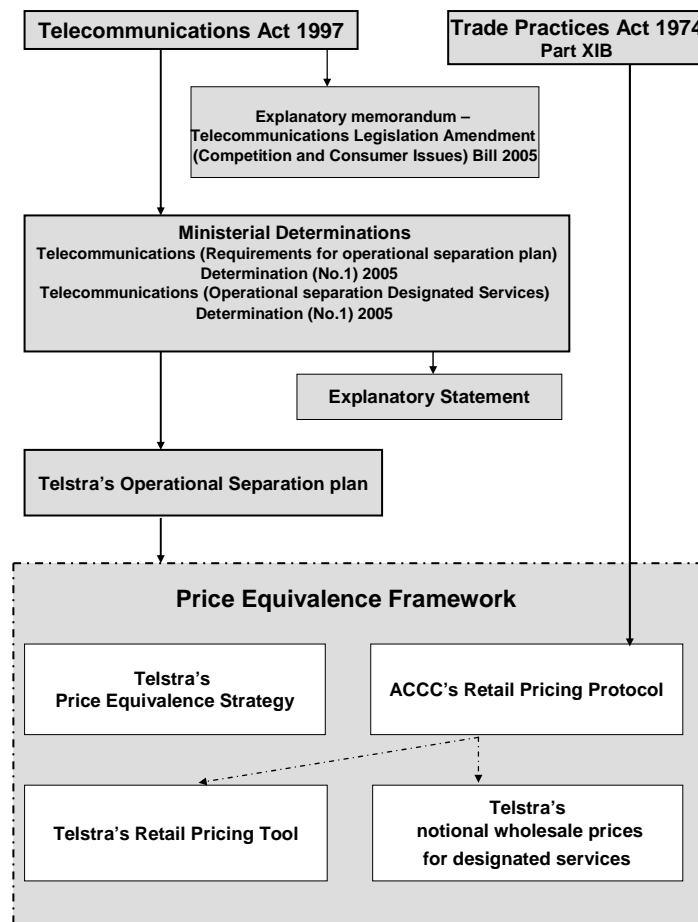
<sup>8</sup> Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, page 19

## 2 Price equivalence and the ACCC's role

In this section of the protocol, the ACCC sets out the legislation governing the ACCC's role concerning Telstra's compliance with operational separation, including price equivalence.

### 2.1 Legislative basis

Figure 1 provides an overview of the legislative regime surrounding price equivalence and the operational separation of Telstra.



#### 2.1.1 Telecommunications Act

Part 8 of the *Telecommunications Act 1997* states the aim of operational separation is to promote the principles of transparency and equivalence in relation to the supply by Telstra of designated services to its wholesale customers and retail business units. Under this Act, Telstra must submit to the Minister an OSP which is directed towards the achievement of the aim and objectives of operational separation.

### 2.1.2 Ministerial Determination

Under s.51(1)(a) of the Telecommunications Act, the Minister issued the *Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1)*. The Explanatory Statement to this Determination noted that the ACCC's role is to:

...develop a retail pricing protocol that will assist the ACCC in interpreting IWPs (Internal Wholesale Prices) and assessing anti-competitive behaviour under Part XIB of the TPA in relation to the pricing of retail services.<sup>9</sup>

The Explanatory Statement to the Ministerial Determination also outlined that the establishment of, and compliance with, the PEF are to be based on the underlying principles that the PEF:

- should seek to simplify and make more transparent the relationship between Telstra's wholesale prices and the prices of its relevant retail services;
- should focus on services and markets where bottleneck characteristics and significant market power exist;
- recognises Telstra's legitimate entitlement to benefit appropriately from any relevant efficiency advantages it may have;
- complements Part XIB of the TPA but does not duplicate, replace, limit or extend the substantive legal obligations imposed under Part XIB; and
- is consistent with the obligations on Telstra under Part XIB.<sup>10</sup>

### 2.1.3 Telstra's operational separation plan

Section 5 of Telstra's OSP relates to the promotion of equivalence in relation to designated services. In relation specifically to price equivalence, Telstra's OSP outlines that the PEF will reflect the following principles:

- the price equivalence framework should focus on services and markets where there are bottlenecks such that there is a significant concern that pricing behaviour may raise concerns about compliance with the TPA;
- the price equivalence framework should not impose unreasonable costs or delays on Telstra and should allow Telstra to obtain legitimate benefits from vertical integration;
- the price equivalence framework does not duplicate, replace, affect or extend the TPA but will be consistent with that Act;

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<sup>9</sup> Explanatory Statement, *Telecommunications Act 1997*, Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005, Part 4, clause 13.

<sup>10</sup> Explanatory Statement, *Telecommunications Act 1997*, Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005, Part 4, clause 13.

- the implementation of a price equivalence framework will not directly affect Telstra's pricing conduct or pricing decisions nor is it a price setting mechanism;
- the price equivalence framework should provide the ACCC with greater transparency and understanding of Telstra's pricing behaviour, and will enable the ACCC to provide public assurances about the degree of transparency available to it (which, for the avoidance of doubt, does not include allowing the ACCC to disclose to the public or a wholesale customer any pricing strategy of a Retail Business Unit);
- outcomes resulting from the application of the price equivalence framework will not be determinative of whether Telstra has or has not acted inconsistently with the TPA and any test results will remain confidential; and
- the ACCC will not be inhibited in its exercise of its functions under Parts XIB and Part XIC of the TPA by any material resulting from, or by the application of, the price equivalence framework.<sup>11</sup>

In addition, Telstra's OSP notes that the PEF will set out the arrangements and approach under which it will conduct imputation tests and consider results from those tests to assess proposals for material price changes for its designated services. Telstra's OSP outlines that the PEF will comprise:

- (a) Telstra's Price Equivalence Framework Strategy, which is expected to set out how the price equivalence framework will apply to material price changes proposed by Telstra for Designated Services and to generally describe the elements of the price equivalence framework including:
  - i) a description of the customer classes to which the price equivalence framework will apply;
  - ii) a work plan and timeline describing the implementation dates for each of the elements of the price equivalence framework;
  - iii) a description of the periodic reporting arrangements to the ACCC in relation to the price equivalence framework; and
  - iv) a description of the way the Annual Compliance Report will include an update on progress against the work plan and timeline referred to in clause 5.3(a)(ii) [of Telstra's OSP];
- (b) Telstra's Retail Pricing Tool, which is a set of imputation tests that seek to assess the impact that Telstra's price changes would likely have on the margin available to an efficient competitor. The Retail Pricing Tool is expected to be applied by Telstra in accordance with the terms of the Price Equivalence Framework Strategy to test material price changes proposed by Telstra for Designated Services before those price changes are generally released to the market. The Retail Pricing Tool

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<sup>11</sup> Telstra's Operational separation plan 23 June 2006, page 9.



will require amendment from time to time to reflect such changes as new market developments, changes to inputs and improvements in the testing methodology;

- (c) a schedule of notional wholesale prices for Designated Services to be considered by Telstra as an input to the Retail Pricing Tool. The schedule will require amendment from time to time to reflect such changes as new market developments, changes in prices and demand and improvements in the testing methodology; and
- (d) the ACCC's Retail Pricing Protocol (where such a protocol has been developed by the ACCC), which will specify the ACCC's views on methodological issues for Telstra's consideration in the Retail Pricing Tool and describe how the imputation test results derived from the Retail Pricing Tool will be interpreted by the ACCC in assessing allegations of vertical price squeezes.”<sup>12</sup>

#### **2.1.4 Telstra's Price Equivalence Framework Strategy**

Telstra released its Price Equivalence Framework Strategy<sup>13</sup> on 30 June 2006, which describes how it considers the PEF will apply to material price changes proposed by Telstra for designated services and relevant retail services. It also generally describes the elements of the PEF.<sup>14</sup>

Telstra states in its PEF Strategy that it may update its PEF Strategy and its Retail Pricing Tool from time to time.<sup>15</sup>

## **2.2 Part XIB and relationship to operational separation**

The ACCC has a number of obligations and functions in relation to operational separation and, more specifically, the concept of price equivalence:

- An obligation imposed in Parts XIB and XIC of the TPA whereby the ACCC must have regard to Telstra's conduct in complying with the final operational separation plan, to the extent that the conduct is relevant;
- Under the Telecommunications Act, the ACCC has the function of preparing a retail pricing protocol, and providing guidance as to how the ACCC will assess pricing conduct under Part XIB of the TPA relevant to services designated under the operational separation provisions; and
- Also under the Telecommunications Act, the ACCC has the function of investigating potential contraventions of the final operational separation plan and reporting on such matters to the Minister.

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<sup>12</sup> Telstra's Operational separation plan, 23 June 2006, pages 9–10.

<sup>13</sup> The strategy can be found at: [http://telstrawholesale.com/custsupp/performance\\_separation.cfm](http://telstrawholesale.com/custsupp/performance_separation.cfm)

<sup>14</sup> Telstra, Price Equivalence Framework Strategy, 30 June 2006, page 2.

<sup>15</sup> Telstra, Price Equivalence Framework Strategy, 30 June 2006, page 2.

These obligations and functions potentially overlap with the some of the ACCC's role under Part XIB of the TPA.

### **2.2.1 Having regard to Telstra's conduct in compliance with the operational separation plan**

The *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005* inserted sections, s151CP, at the end of Part XIB and s152EQ at the end of Part XIC of the TPA which concerns the potential for overlaps between operational separation and Part XIB and Part XIC. These sections apply where Telstra has engaged in conduct in order to comply with a final operational separation plan and require the ACCC in performing a function or exercising a power under Part XIB or Part XIC, to have regard to Telstra's conduct to the extent that the conduct is relevant.

### **2.2.2 Equivalence in pricing and Part XIB**

The key objective of the price equivalence and operational separation as outlined in the Explanatory Memorandum to the *Telecommunications Legislation Amendment (Competition and Consumer Issues) Bill 2005*, is to provide ongoing assurance to the market that Telstra is not favouring its retail business units by implicitly supplying services to itself at prices which are unjustifiably lower than those offered to downstream competitors.

One way to measure whether services are implicitly being supplied at a lower price is to consider whether Telstra's retail unit could make an economic profit supplying services in the retail market if it actually had to pay 'equivalent' wholesale charges to competitors. If Telstra could show that this is the case, then it would provide some assurance that the wholesale service was being supplied on equivalent terms, as it would allow relative efficiency to determine the respective positions of suppliers in the downstream market.

It can be seen that this approach essentially links 'equivalent' wholesale pricing back to the competition law concept of a 'vertical price squeeze' (price squeeze), which in the context of telecommunications markets, is normally addressed by the ACCC using Part XIB of the TPA. The Government determined this as a light-handed approach which could complement Part XIB (i.e. failure of an imputation test does not necessarily lead to action under Part XIB).

Note that a more heavy-handed approach would be to limit Telstra from implementing proposed price changes in the event that it fails an imputation test. Presumably under this approach, failure of an appropriately specified imputation test would lead to the conclusion that prices are not equivalent. It should be emphasised that nothing in the legislation or the OSP implies such limitations.

### **2.2.3 Part XIB, the competition rule and vertical price squeezes**

Section 151AK of the TPA prohibits a telecommunications carrier or carriage service provider from engaging in anti-competitive conduct. This prohibition is known as the competition rule.

If the ACCC has ‘reason to believe’ that a carrier or carriage service provider has engaged, or is engaging, in an instance of anti-competitive conduct, it may issue a Part A competition notice under s.151AKA of the TPA.

From time to time, the ACCC has been called on by competing carriers and carriage service providers to issue a Part A competition notice to Telstra for alleged price squeezes.

A price squeeze is a form of anti-competitive ‘low’ pricing.<sup>16</sup> A price squeeze can occur where a vertically integrated firm uses its market power over the supply of a key input to reduce the margin available to competitors to whom it supplies the key input and also competes against in the downstream market. A price squeeze can be identified by the use of imputation testing.

In simple terms, imputation testing involves a comparison of:

- the retail prices charged by the vertically-integrated firm for the downstream service; and
- the wholesale price charged by the vertically-integrated firm for the upstream service, plus the additional costs incurred in transforming the wholesale service into the retail service.

Where the retail price is less than the sum of the wholesale price and appropriately allocated additional costs, a price squeeze is said to exist under certain market conditions.

The ACCC considers that if an appropriately constructed imputation test shows that a price squeeze does not exist, this would be indicative of Telstra implicitly supplying the relevant wholesale service on equivalent terms.

Having said that, it is important to note that there is not a direct relationship between equivalence and price squeeze concepts and a contravention of the competition rule.

Rather, anti-competitive conduct for the purposes of the competition rule is defined in s.151AJ of the TPA as occurring in two circumstances:

- Where a carrier or carriage service provider has a substantial degree of power in a telecommunications market and takes advantage of that power with the effect or likely effect of substantially lessening competition in that or any other telecommunications market;<sup>17</sup> or

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<sup>16</sup> A price squeeze is closely related to predatory pricing, although the ‘low’ pricing refers to the retail price in relation to wholesale price, rather than in relation to cost as per predatory pricing.

<sup>17</sup> Section 151AJ(2) provides:

A carrier or carriage service provider engages in anti-competitive conduct if the carrier or carriage service provider:

(a) has a substantial degree of power in a telecommunications market; and

- Where a carrier or carriage service provider engages in conduct which would contravene sections 45, 45B, 46, 47 or 48 of the TPA where that conduct relates to a telecommunications market.<sup>18</sup>

Telstra's price equivalence imputation tests should provide a starting point for more detailed analysis of price squeezes for retail services that use the designated wholesale services on a case by case basis. The ACCC does not consider the failure of an imputation test to be determinative of a breach of the competition rule. For a price squeeze to constitute anti-competitive conduct, it is required to take advantage of a substantial degree of power in a telecommunications market with the effect or likely effect of substantially lessening competition or otherwise contravenes sections 45, 45B, 46, 47, 48 of the TPA. Conversely, passing an imputation test does not guarantee that the pricing conduct is not anti-competitive.

Given that an imputation test will not necessarily identify a substantial lessening, preventing or hindering of competition, the ACCC will normally supplement imputation test results with an examination of the effect or likely effect of the price squeeze on competition. This could include the assessment of a range of factors, including one or more of the following:

- The effect of the conduct within the context of the relevant downstream market;
- Barriers to entry in that downstream market;
- Retail pricing behaviour of market participants;
- The actual or likely temporal effect of the conduct;
- Characteristics of the market, including actual or likely growth or decline;
- Current and likely profitability of market participants and/or potential entrants in relation to particular products and services and/or across a number of products and services;
- The actual or likely effects of the conduct upon potential entrants;

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(b) either:

- (i) takes advantage of that power with the effect or likely effect of substantially lessening competition in that or any other telecommunications market; or
- (ii) takes advantage of that power and engages in other conduct on one or more occasions with the combined effect or likely combined effect of substantially lessening competition in that or any other telecommunications market

<sup>18</sup> Section 151AJ(3) provides:

A carrier or carriage service provider “engages in anti-competitive conduct” if the carrier or carriage service provider:

- (a) engages in conduct in contravention of section 45, 45B, 46, 47 or 48; and
- (b) the conduct relates to a telecommunications market.

- The actual or likely effect of the conduct on the ability of market participants to acquire new customers, expand product offerings and/or deploy alternate technologies to offer products or services; and
- Other factors that the ACCC considers relevant.

The ACCC may not consider it necessary to examine all of these factors in relation to every alleged price squeeze. Similarly, the ACCC may not consider it necessary to examine all such factors to find a reason to believe that a carrier or carriage service provider has engaged, or is engaging, in anti-competitive conduct.

The issue of vertical price squeeze has been previously considered by the ACCC, and interested parties will be aware that the ACCC has consulted on this issue and imputation tests before. The ACCC has released the following publications which deal with these issues, *Assessing vertical price squeezes for ADSL services, an ACCC information paper* (2005); *Bundling in Telecommunications markets* (2003);<sup>19</sup> and *Anti-competitive Conduct in Telecommunications Markets* (1999).<sup>20</sup> These principles remain relevant and parties should consult these documents in conjunction with the further principles detailed in this information paper. The Retail Pricing Protocol can be considered supplementary to these publications.

#### **2.2.4 Part XIB and the Imputation testing Record Keeping Rules (RKR)**

On 19 June 2003, the Minister for Communications, Information Technology and the Arts directed the ACCC to use its record-keeping rule (RKR) making powers under the TPA to introduce enhanced accounting separation of Telstra.

In accordance with this direction, the ACCC issued RKRs requiring Telstra to provide the ACCC with amongst other things, quarterly imputation testing reports comparing Telstra's retail prices and the costs faced by access seekers in purchasing core services<sup>21</sup> from Telstra to supply competing retail services.

The primary objective of the reports provided under the imputation RKRs is to indicate whether Telstra is engaging in systemic price squeeze behaviour in relation to core telecommunications services. However, as noted above, the pass or failure of an imputation test is not determinative of a contravention of the competition rule.

The direction requires that the imputation tests be made public to improve transparency about potential price squeezes for core telecommunication services.

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<sup>19</sup> This paper followed a consultancy report prepared by NERA for the ACCC, *Imputation Tests for Bundled Services*, August 2003. This paper is available at [www.accc.gov.au](http://www.accc.gov.au)

<sup>20</sup> These papers are available at [www.accc.gov.au](http://www.accc.gov.au)

<sup>21</sup> Core services refer to wholesale services—the local carriage service, domestic PSTN originating service, domestic PSTN terminating service and unconditional local loop service—that are the underlying services in the provision of certain retail services.

The imputation testing RKR provide the ACCC and the public with a reliable indicator of trends in the margins that are likely to be available to competitors no less efficient than Telstra and as such provide a useful information set for industry. They also provide a useful starting point for ACCC investigations under Part XIB and / or Part XIC of the TPA based upon cost data that is able to be verified against Telstra's statutory financial statements.

The ACCC recognises that there is some potential for the imputation RKR to be duplicated by imputation tests conducted under the PEF as they are both designed with similar goals in mind. However, as elaborated in the following sections, there are some important differences between the imputation testing RKR and the price equivalence imputation tests. Most notably, under the framework surrounding the price equivalence imputation tests:

- the ACCC does not have the ability to publish imputation test results;
- some customer segments covered by the RKR are not included (i.e. corporate customers);
- imputation tests will be performed on the occurrence of a 'material' price change;
- the price equivalence imputation tests are conducted on an ex ante basis

The differences between the price equivalence imputation tests and the imputation test RKR are discussed in greater detail in later sections of this information paper, as is the potential to harmonise these arrangements.

### 3 Price equivalence imputation testing

In this section of the protocol, the ACCC outlines:

- the services, markets and customers groups to which it understands price equivalence imputation tests are to apply; and
- its views on which price equivalence imputation tests should be conducted in the Retail Pricing Tool in order to minimise the extent to which conduct is likely to breach Part XIB of the TPA.

#### 3.1 Choice of designated services

The general principle of price equivalence is that Telstra will undertake price equivalence imputation tests in the event of a wholesale price increase for designated services, or a retail price decrease with respect to services that use the designated services, subject to a materiality threshold.

The Ministerial Determination *Telecommunications (Operational Separation – Designated Services) Determination (No. 1) 2005* specifies Telstra's designated services as those active declared services which are described in the relevant ACCC declarations as well as Wholesale ADSL (Layer 2)<sup>22</sup>. It is expected that the description of a designated service will be affected by any changes or exceptions to the relevant ACCC declaration to ensure that the description remains relevant and consistent. The services specified in this Ministerial determination as being designated services are:

- Wholesale ADSL (Layer 2);
- Domestic PSTN Originating Access Service;
- Domestic PSTN Terminating Access Service;
- Unconditioned Local Loop Service;
- Local Carriage Service;
- Line Sharing Service; and
- Domestic Transmission Capacity Service.<sup>23</sup>

#### 3.2 Materiality

If Telstra were required to undertake price equivalence imputation tests every time it implemented a price change, there would be the potential for it to undertake and report to the ACCC the results of an excessively large number of imputation tests. Such a

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<sup>22</sup> Wholesale Layer 2 is not a declared service.

<sup>23</sup> Telecommunications (Operational Separation – Designated Services) Determination (No. 1) 2005, 'Schedule – Active declared services determined as designated services'.

requirement could be overly onerous, resulting in unnecessary reporting and analysis for both Telstra and the ACCC.

As such the ACCC considers that price equivalence imputation tests should only apply to **material** price changes, the aim being to capture situations where the potential for contravention of the TPA is present and, in particular, there is a more significant risk of the price changes leading to a substantial lessening of competition. That is, Telstra will primarily undertake price equivalence imputation tests when it is considering making material price changes, rather than on a periodic basis.

The potential for periodic tests for the purpose of better achieving transparency in available margins is discussed further below.

The ACCC considers the initial materiality threshold should be based on percentage-change-in-revenue, with the initial threshold set at 3 per cent of incremental revenue. That is, where a given price change for the service in question results in a 3 per cent or greater change in incremental revenue from that service Telstra must conduct imputation testing. Where price changes are temporary, the change in incremental revenue will be calculated consistent with the time period of the temporary price.

This approach will be kept under review to ensure that in practice it is providing appropriate trigger points. On the one hand, given that a wide range of factors can influence imputation margins in addition to price changes, and also that a series of targeted price changes could be made without triggering a test requirement, there is the potential for significant changes in imputed margins to occur between tests being conducted. On the other hand, revenue changes of 3 percentage points or more may not translate into material reductions in margins in all cases.

Accordingly, the ACCC may initiate a revision to this approach, or may adjust the chosen benchmark during or after implementation, if necessary. The ACCC recognises that the level of the materiality threshold is a matter of some judgement and considers that Telstra should use 3 per cent of incremental revenue as the initial threshold.

The ACCC considers that Telstra's Retail Pricing Tool should provide for the standard imputation tests to be conducted where a given price change for the service in question results in a 3 per cent or greater change in incremental revenue from that service.
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### **3.3 Price equivalence imputation tests**

An imputation test relates to the relationship (or margin) between prices for wholesale and retail services. Accordingly, it is necessary to 'map' the designated services against the relevant downstream (retail) services. Table 1 shows the proposed relationships between the designated services and their associated retail product alignment for price equivalence imputation testing. Attachment 1 outlines the definitions for these relevant retail services.



**Table 1. Designated services and associated retail product alignment for price equivalence imputation testing**

	<b>Designated Services</b>	<b>Relevant retail services</b>
<b>1</b>	<ul style="list-style-type: none"> <li>▪ Domestic PSTN Originating Access Service</li> <li>▪ Domestic PSTN Terminating Access Service</li> <li>▪ Local Carriage Service (LCS)</li> <li>▪ Domestic Transmission Capacity Service</li> </ul>	<ul style="list-style-type: none"> <li>▪ Standard Telephone Service and local calls</li> <li>▪ National long distance calls</li> <li>▪ International long-distance calls</li> <li>▪ Fixed-to-mobile calls</li> </ul>
<b>2</b>	<ul style="list-style-type: none"> <li>▪ Domestic PSTN Originating Access Service</li> <li>▪ Domestic PSTN Terminating Access Service</li> <li>▪ Local Carriage Service (LCS)</li> <li>▪ Domestic Transmission Capacity Service</li> <li>▪ Wholesale ADSL Layer 2 Service</li> </ul>	<ul style="list-style-type: none"> <li>▪ Standard Telephone Service and local calls</li> <li>▪ National long distance calls</li> <li>▪ International long-distance calls</li> <li>▪ Fixed-to-mobile calls</li> <li>▪ BigPond ADSL</li> </ul>
<b>3</b>	<ul style="list-style-type: none"> <li>▪ Unconditioned Local Loop Service (ULLS)</li> <li>▪ Domestic Transmission Capacity Service</li> <li>▪ Domestic PSTN Terminating Access Service</li> </ul>	<ul style="list-style-type: none"> <li>▪ Standard Telephone Service and local calls</li> <li>▪ National long distance calls</li> <li>▪ International long-distance calls</li> <li>▪ Fixed-to-mobile calls</li> <li>▪ BigPond ADSL</li> </ul>
<b>4</b>	<ul style="list-style-type: none"> <li>▪ Line Sharing Service (LSS))</li> <li>▪ Domestic Transmission Capacity Service</li> </ul>	<ul style="list-style-type: none"> <li>▪ BigPond ADSL</li> </ul>
<b>5</b>	<ul style="list-style-type: none"> <li>▪ Wholesale ADSL Layer 2 Service</li> <li>▪ Domestic Transmission Capacity Service</li> </ul>	<ul style="list-style-type: none"> <li>▪ BigPond ADSL</li> </ul>

Often Telstra's designated services will be seen as a bundle of particular network elements and there are also some retail services which can be provided in multiple ways using different designated services. Consequently there are multiple price equivalence imputation tests which could be employed. For example, BigPond ADSL could be provided by either purchasing the Wholesale ADSL Layer 2 service and the Domestic Transmission Capacity Service or by purchasing LSS and the Domestic Transmission Capacity Service.

The ACCC is of the view that the price equivalence imputation tests contained in Telstra's Retail Pricing Tool should be largely undertaken on a bundled basis as set out in Table 1. The rationale underlying the format for these tests is discussed in detail in

section 4.1.7. In addition, the ACCC expects that Telstra will provide it with details of the revenues, costs and volumes associated with each of the relevant retail service components within each of the bundled tests, along with the method used to allocate any common costs, which would essentially permit the results for the unbundled tests to be observed. A template for reporting to the ACCC the price equivalence imputation test results on this basis is provided at Appendix 2.

One approach for undertaking imputation tests where retail services can be provided by alternative designated services, is to use the bundle of designated services which allows the ‘most efficient’ provision of the relevant retail service. However, defining what the most efficient provision of a retail service is an inherently subjective task. In addition, in some circumstances this approach may not always reflect market realities.

The ACCC considers that in order to provide Telstra with a level of certainty that its prices are equivalent, it is necessary that where retail services can be provided by alternative designated services, each of the relevant imputation tests outlined in Table 1 should be undertaken. The ACCC is of the view that each of these tests provides different information, all of which can be useful in assessing conduct and the likely effects of that conduct where alternative designated services can be used.

The ACCC notes that the equivalence concept applies to all designated services, so the default position should be that any test failure would be indicative of non-equivalence. That said, the ACCC recognises that in particular circumstances any one of the tests may not on its own provide a definitive insight into the implications of non-equivalence. Nonetheless, a failed imputation test should not be ignored, nor should imputation testing only be conducted using Telstra’s assessment of what the most efficient provision of the relevant retail service is.

The ACCC considers that the model of operational separation specified under the *Telecommunications Act 1997* places the onus on Telstra to demonstrate that its pricing is equivalent. It therefore follows that, in the first instance, Telstra should pass all of the relevant tests outlined above. A failure of one test will not be determinative of anti-competitive conduct, but it would generally be the type of conduct that could warrant further examination by the ACCC.

The ACCC considers that in general, Telstra’s Retail Pricing Tool should undertake separate imputation tests with each of the relevant designated services and their associated downstream (retail) product alignment as specified in Table 1.

### **3.4 Application to retail market segments**

There is a question as to whether price equivalence should apply to all retail customers or just certain market segments. The relevant retail services identified above (which uses one or more designated services as a wholesale input) may be supplied in different markets (i.e. there may be separate markets for services provided to large businesses and small business customers).

The ACCC is of the view that the application of an *ex ante* price equivalence imputation tests to large corporate customers is more complex and that, at this stage,

the focus of price equivalence would be best directed to residential and non-corporate business customers. However, as the scope of the price equivalence imputation testing is limited to residential and non-corporate business customers, it follows that the ACCC cannot provide any guidance to Telstra about the degree to which pricing equivalence has applied for the supply of the excluded corporate customers.

The ACCC considers price equivalence imputation tests should be applied in the event of a wholesale price increase for designated services, or a retail price decrease with respect to the relevant retail services specified in Table 1 for both residential and non-corporate business customers that use the designated services (i.e. these events are the trigger for Telstra to undertake imputation tests). The revenue base for the relevant retail service should therefore exclude revenue from the corporate segment.

The removal of corporate customers from price equivalence imputation testing may raise issues about the cost allocation between residential, non-corporate business, and corporate customers.

For the purposes of delineating corporate markets, the ACCC considers that corporate customers should be defined as per the ACCC's report '*Competition in corporate customer segments of the telecommunications industry January – December 2004*'.<sup>24</sup> This proposes a definition of the corporate segment as being the top 1200 firms by annual revenue and government customers with contracts in excess of \$2 million per annum.

As an alternative, it may be possible that broader price equivalence could be sought through a different framework that excludes customers that are serviced by a Telstra retail business unit that deals only with large business and government customers.

The ACCC considers that in general, the standard imputation tests contained in Telstra's Retail Pricing Tool should be applied in the event of a wholesale price increase for designated services, or a retail price decrease with respect to the relevant retail services for both residential and non-corporate business customers that use these services.

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<sup>24</sup> This report can be found at [www.accc.gov.au](http://www.accc.gov.au)

## 4 Key principles and vertical price squeeze issues— ACCC views

This section sets out the ACCC's views on a number of methodological principles for conducting price equivalence imputation tests. The ACCC would generally follow these principles in addressing price squeeze allegations under Part XIB. Accordingly Telstra should follow these principles as far as practicable in its Retail Pricing Tool.

The objective is to provide guidance for interested parties (including Telstra) as to how the ACCC is likely to approach these issues if allegations of a price squeeze are made about designated wholesale and associated retail services.

### 4.1.1 Objective of imputation tests used under operational separation

Imputation tests conducted under Telstra's proposed Retail Pricing Tool should be designed to answer the question of whether its wholesale and retail pricing is likely to result in a price squeeze. In doing so, Telstra's tests should be focused on pricing conduct that has the potential to substantially lessen competition, as these tests would be most relevant for the purposes of identifying breaches of the competition rule. In saying this, the ACCC recognises that it would be very difficult – if not impossible – to define *ex ante* a single imputation test that would be determinative of whether pricing was or was not anti-competitive.

The ACCC's general view is that Telstra's imputation tests should be constructed to identify whether Telstra's combination of wholesale charges and retail prices is such that competitors at least as efficient as Telstra can make a normal profit<sup>25</sup> and / or remain viable in the relevant downstream market in which the retail services are supplied.

Constructing tests in this way will mean that Telstra's actual downstream costs (not those of actual competitors) will be used in the imputation test. This will account for competition effects only to the extent that other suppliers are at least as efficient as Telstra in serving the downstream market. If they are less efficient (i.e. Telstra's costs are lower), it is likely to be unreasonable to prevent Telstra from lowering its retail prices as this may result in the protection of inefficient competitors. A corollary of this position is that Telstra should be allowed to benefit from efficiencies that it is able to generate in respect of transformation costs in serving the downstream market. To the extent that these economies lead to lower costs, then Telstra should be allowed to pass these on to consumers, and the test would be consistent with the concept that competition should allow efficient suppliers to displace those suppliers that are less efficient. From a more practical perspective, it is also preferable to use Telstra's costs in the test as in most cases Telstra could not reasonably expect to know its competitors' costs.

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<sup>25</sup> A 'normal' profit differs from an accounting profit. A normal profit includes an economic rate of return on the specific investments made in the business, to reflect their opportunity cost.

The ACCC's general view is that the standard imputation tests contained in Telstra's Retail Pricing Tool should be constructed to identify whether Telstra's combination of wholesale charges and retail prices is such that competitors at least as efficient as Telstra can make a normal profit and / or remain viable in the relevant downstream market in which the retail services are supplied.

#### 4.1.2 Calculating IWPs

In undertaking an imputation test it is necessary to identify an appropriate price for Telstra to charge itself to use its wholesale inputs. There is a question surrounding which wholesale price should be used in an imputation test where there are a number of prices available. While the IWPs can be calculated using a number of different methods, two approaches have been identified for considering price equivalence:

1. an unadjusted IWP, based on the lowest price that is available from Telstra to a wholesale customer for a designated service;
2. a wholesale yield.<sup>26</sup>

The existing RKR imputation tests pursuant to s151BU of the TPA adopt a wholesale yield approach. As noted above, the ACCC's position is that imputation tests are designed to ensure that competitors no less efficient than Telstra can compete with Telstra in downstream markets or, under an alternative formulation, that Telstra is not sacrificing profits by supplying the service itself at the retail level, rather than allowing the wholesale customer to supply the retail service.

In relation to the first approach (i.e. 'lowest' price), the ACCC's primary concern is that smaller but more or equally efficient downstream competitors could be eliminated simply because arbitrary access price discrimination means they cannot match Telstra's retail prices (which would be based on a lower imputed wholesale price).

Consequently, there is a risk that adopting the 'lowest' wholesale charge approach, where the discount off the headline access prices is not cost-justified, will result in the elimination of competitors not receiving this price (in the limit, if this price is only available to Telstra, it may provide justification for the elimination of all competitors).

A wholesale yield approach, while still problematic if it is not reflective of cost savings from supplying larger customers (in which case it might be argued that the highest price in the market should be used), would provide a more reasonable approach as (at the least) it would reflect market realities such as the actual purchase patterns of wholesale customers.

For this reason, the ACCC considers a wholesale yield approach should be used. However, the ACCC will consider tests based on other approaches if it can be demonstrated that they are more appropriate in all circumstances.

The ACCC considers that the standard imputation tests contained in Telstra's Retail Pricing Tool should be based on a wholesale yield approach.

<sup>26</sup> Wholesale yield can be defined as the average access price for a service estimated by dividing its total revenue by total volume.

#### **4.1.3 Relevant transformation costs**

Economic theory provides a number of cost standards to assess the cost of transforming wholesale inputs into the downstream retail product(s) and service(s). The ACCC is of the view that the appropriate cost concept is long run avoidable or incremental cost. That is, Telstra's average retail prices should exceed wholesale charges plus the additional long-run incremental retail transformation costs of supplying the relevant service.

An incremental (or avoidable or marginal) cost standard is used because if these costs are recovered, then Telstra is, by definition, no worse off from supplying a service at the retail level.

In general, the ACCC considers a long run cost standard to be appropriate as it is reasonable to expect that decisions to cease (or commence) supplying a specific retail service (or group of services) will generally be made with a view to the expected profits over a time horizon in which most, if not all (non-sunk) costs relevant to the output increment in question will be variable.

The importance of time horizon for which the imputation testing relates will depend on the extent to which the proportion of costs that are avoidable varies with the length of time. In order for the ACCC to properly assess a price squeeze allegation, the time frame in which retail and wholesale prices are assessed should be consistent with the time frame over which retail transformation costs are assessed. This is considered further in section 4.1.6 below.

The ACCC considers that in general the appropriate cost concept to be used in the standard imputation tests contained in Telstra's Retail Pricing Tool is long run avoidable or incremental cost.

#### **4.1.4 Relevant customer base**

This issue relates to treatment of revenues obtained from a particular sub-set of customers which can be differentiated from the full customer base. Examples of customer sub-sets include; old and new customers, entry level and heavy user customers, low spend and high spend customers and customers from different geographic areas.

The ACCC has previously noted the aggregated nature of the imputation tests in the existing imputation testing RKR means that the tests will not necessarily provide an accurate reflection of the actual commercial situation faced by efficient competitors. That is, aggregated imputation tests have the potential to mask anti-competitive behaviour which more disaggregated tests may be able to detect.

One example of the treatment of revenues from a particular sub-set of customers is in relation to customers on superseded plans. Customers on superseded plans are those who do not take up a superior package or price when it is offered, but instead remain (for whatever reason) on a higher-priced and more profitable plan. To illustrate how these customers affect the results of the imputation test, consider a situation where all

customers joining new plans were loss making for Telstra,<sup>27</sup> but customers remaining on existing plans were profitable. Then it is possible that Telstra could pass an imputation test by ‘cross-subsidising’ loss-making new customers on the new plans with profits from customers on existing plans. However, whether a more or equally-efficient competitor could compete would depend on whether that competitor was assumed to have an existing customer base on which excess profits could be made in a similar manner. Clearly more efficient new entrants would not have such capacity.

One approach to this issue is that assessments could be based on all revenues associated with the full customer base, regardless of whether relevant customer sub-sets exist. Such an assessment would include all incremental revenue or other commercial benefit expected to be received through supply of the relevant retail services and any revenue or other commercial benefit that would be, or would likely to be, otherwise lost if Telstra did not supply that retail service.

The implications of only including the revenues from relevant customer sub-sets will depend on the facts at hand. While in many circumstances the ACCC considers an assessment based on the full customer base is valid, in other instances it may be appropriate for the ACCC to consider revenues from supplying particular sub-sets of customers. This may be more so if, for example, there was specific pricing differentiation that emerged (e.g. geographic, or to certain types of customers) which was targeted specifically at competitors or exploited particular Telstra advantages or otherwise prevented or inhibited the entry or expansion of efficient competitors.

More broadly, the ACCC has concerns that a test of profitability across the total customer base that was passed solely due to the inclusion of revenues from a sub-set of customers may falsely indicate that new or existing competitors would be able to compete aggressively for new customers. The ACCC considers that where a market may be expected to expand over the next few years then conduct which prevents the entry or expansion of competitors could be indicative of a lessening of competition.

The ACCC considers that in general the standard imputation test to be applied in Telstra’s Retail Pricing Tool for the purposes of demonstrating price equivalence should consider the full customer base; however in specific instances it may be appropriate for Telstra’s Retail Pricing Tool to consider particular sub-sets of customers.

#### **4.1.5 Forward looking tests**

In assessing a potential price squeeze an imputation test can be conducted on a forward looking (*ex ante*) or backward looking (*ex post*) basis. A common *ex post* method is to use an (historical) accruals accounting approach, for example, by comparing average prices to average variable costs. By contrast, imputation tests conducted on an *ex ante*

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<sup>27</sup> That is, over their expected customer life, the revenues received from these customers will not cover the upfront and ongoing costs from acquiring and serving these customers.

basis use forecast information and commonly use a discounted cash flow (DCF) measure of profitability.<sup>28</sup>

The ACCC believes that both *ex post* and *ex ante* approaches can usefully address the question of whether there is a price squeeze, but they do so in different ways and are suitable in different circumstances.

Commonly, competition authorities assess forms of anti-competitive pricing (such as price squeeze or predation) using *ex post* measures of profitability. This appears to be primarily because the relevant question addressed is whether a firm has actually made a loss over the time period alleged. An *ex ante* approach, by contrast, is better suited to answering the question of whether losses will be likely to be incurred in future as a result of a particular price change or changes. The primary disadvantage with the *ex ante* approach is that it may be unclear why a price change is profitable—for example, it may be due to margins in later periods building in the rewards from less competition or anti-competitive conduct.

The current RKR imputation tests contain both historical accounting data and current cost data. The tests themselves are conducted on an *ex post* basis, and hence it is better suited to analyse the question of whether Telstra's margins were 'too low' in the past. In undertaking price equivalence imputation tests, it is necessary to consider which approach should be taken.

In the ACCC's previous paper on ADSL price squeezes, it was noted that an *ex ante* approach is in many cases appropriate to use in an immature market as it accounts for the fact that historical data may not be the best forecast of what is likely to happen in the future (e.g. that reasonable forecasts may not be met) and limits problems associated with accounting distortions (if these are significant).

Having said that, where markets are more mature and outcomes more certain, it might be more reasonable to use an *ex post* accounting approach, allocating costs to particular periods, and assess profitability on a monthly or quarterly basis (as occurs under the imputation RKRs). Such tests, however, do not allow for ready assessment of price changes, since the data in such tests is subject to significant lags.

The ACCC's view is that it may be more appropriate for the imputation testing under the PEF to be forward-looking. This necessarily implies a greater use of forecasts, which are subject to inaccuracy. As a consequence of this weakness, for the imputation test to usefully identify a price squeeze on an *ex ante* basis, the ACCC considers Telstra must take a rigorous approach to ensuring that all inputs and assumptions in the imputation test are as updated and accurate as possible.<sup>29</sup>

Similar to its treatment in relation to existing testing of ADSL services, a rigorous approach would require Telstra to:

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<sup>28</sup> The DCF approach uses an analysis of cash flows to assess the profitability of a business (or business segment) over a single period of time, and costs and revenues are recorded as incurred. The measure of profit is the net present value (NPV).

<sup>29</sup> A further discussion of this point is at ACCC, op. cit., p. 16



- (a) base its forecasts (*e.g.* for demand, cost changes) on actual information (where possible), or alternatively with substantive evidence to support the forecast;
- (b) regularly review the assumptions and forecasts underpinning the imputation test (and, where forecasts were not being met, adjust the forecast and, if necessary, retail or wholesale prices); and
- (c) conduct sensitivity testing on important inputs.

Where Telstra undertakes *ex ante* imputation testing under the PEF, it should ensure that it takes a rigorous approach to ensuring that all inputs and assumptions in such imputations test are as updated and accurate as possible.

#### 4.1.6 Time period for tests

In developing an imputation test, it is necessary to determine the period over which to assess Telstra's pricing conduct. This requires consideration of the period over which it is reasonable for costs associated with transforming the designated services into the retail services to be recovered.

On most occasions this question is straightforward to answer. Where costs and revenues are largely incurred and received at the same time, profitability can readily be assessed over quite short periods. In these cases the ACCC prefers imputation tests to be conducted over a relatively short time frame. The ACCC would only consider that a longer time period would be appropriate where it is clear that the relevant services are maturing such that a short time frame could not be expected to be reasonably indicative of long run margins.

In situations where costs are incurred that deliver services to a firm (*i.e.* an investment in an asset) over a longer time period, then it will be necessary to either allocate those costs to particular time periods (usually in the form of depreciation) or to assess profit over a longer time period (*e.g.* the useful economic life of the asset).

The existing imputation RKR measures profits on a quarterly basis, with the costs of longer-lived assets (*e.g.* retail IT systems) being captured in depreciation charges.

Under an *ex ante* imputation testing approach, which according to Telstra's PEF Strategy it intends to undertake, it is possible to assess profits either in particular periods, such as quarterly or yearly, but this usually requires decisions to be made as to cost allocation over time for longer-lived assets. This might give rise to some uncertainty as to whether costs have been allocated in an economically appropriate way (reflecting the decline in economic value of the assets). Alternatively, the test could consider a longer timeframe that more closely approximates the economic lifetime of the activity. The risk with that type of time period is that it may allow for a pattern of profitability which is inconsistent with competitive market behaviour. For example, the test may report a positive margin overall, but involve steep short term 'losses' which are offset by very high margins in latter periods of the test.

The ACCC considers that the time period for an *ex ante* imputation test must reflect a balance between the expected life of key investments and future uncertainty. This

means that the appropriate time period to adopt in conducting tests as part of an investigation is likely to vary on a case by case basis.

For well-established services that have stable demand patterns, it should be relatively straightforward to establish appropriate paths of cost recovery for long-lived assets, such that it should be possible to obtain accurate testing results over quite short periods (much as occurs with the current imputation RKR, which provide quarterly testing results albeit on a backward looking basis). In other words, the ACCC believes an approach which allowed for short-term losses as a trade-off for longer-term profits is unlikely to be reasonable for well-established services.

Conversely, for rapidly-growing services (such as has been the case with ADSL), it may be more appropriate to only assess the results of an imputation test over a longer period. This would avoid producing misleading results that could arise from the higher set-up costs incurred in the early periods of the business life. That said, such an approach must balance the argument for a longer period of assessment with the recognition that it might allow Telstra to trade-off short term losses with longer term profits (potentially, once its competitors' ability to compete has been diminished). In the ACCC's earlier paper on ADSL price squeezes, it was noted that a 3-year period of profitability assessment was likely to strike a reasonable balance between these considerations.<sup>30</sup> However, specifying a time frame over which an imputation test is to be conducted requires consideration of anticipated market conditions on a case by case basis at the time.

The ACCC considers that where Telstra undertakes *ex ante* imputation testing in its Retail Pricing Tool, the time period for these tests will need to reflect a balance between the expected life of key investments and future uncertainty. This period will likely differ depending on the maturity of the service and the stability of demand.

#### **4.1.7 Approach to bundling**

Telstra and many of its competitors commonly provide communications services to their customers on both a 'stand alone' and a bundled basis. That is, services are able to be purchased independently, or in combination with other services (usually in return for a discount on total service price).

In deriving appropriate imputation tests for the purposes of price equivalence, it is necessary to consider whether and how these tests should take account of this bundling behaviour. For example, whether Telstra should have to pass an imputation test for each call type (e.g. local calls, fixed-to-mobile calls), fixed-telephony bundles (e.g. local calls and line rental) or for all services provided as part of a bundle (e.g. fixed telephony, mobile telephony, ADSL and pay TV services).

There are a number of reasons why firms bundle, but broadly it is driven by either a desire to achieve efficiencies by taking advantage of complementarities in demand or supply, or to leverage a strong market position over one service into the market in which the bundled service is supplied. The ACCC's concern is obviously with the

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<sup>30</sup> ACCC, Assessing vertical price squeezes for ADSL services, May 2005, pg 16.

latter, as bundling behaviour that merely takes advantages of efficiencies (e.g. economies of scope) is not likely to breach the TPA.

That said, it is not usually obvious which of these two rationales is responsible for observed bundling in particular cases. This issue is often an important part of the evidence-gathering process when investigating specific complaints about anti-competitive pricing.

The ACCC has previously noted<sup>31</sup> that its primary bundling concern arises where Telstra uses high margins earned on certain services to ‘cross subsidise’ other loss-making services. In such circumstances, it may be that a broadly-specified imputation test (across all services in the bundle) would show a pass result, even though equally or more efficient competitors who only supplied one of the services would be prevented or hindered from effectively competing in the market in which the loss-making service is provided.

Given that concern, and the general difficulty in identifying whether bundling is driven by efficiency motives, the ACCC has previously been minded to consider the ‘replicability’ of particular Telstra bundles.<sup>32</sup> Where a bundle can be technically replicated (i.e. the input service is widely available) and commercially replicated (i.e. the service is available on cost-based or otherwise commercial terms) by competitors, then it would appear less likely that the bundling behaviour (including the pricing of the bundle) would substantially lessen competition, as competitors could replicate Telstra’s offerings. By contrast, where bundles cannot be replicated, there is potential for the pricing of bundles to lessen competition.

Again, assessing the replicability of a particular bundle does not provide information on whether bundling is likely to be driven by efficiencies, but it does provide information on the effect or likely effect of the bundling behaviour. It may therefore be useful as a guide to determine the relevance of certain price equivalence imputation tests, given the objective of focusing on potential price squeezes that are more likely to substantially lessen competition.

The existing imputation test RKR examines individual fixed-line voice services and the bundle of fixed-line voice services<sup>33</sup>, using local carriage services and PSTN OTA as inputs, and both the bundle of ADSL / fixed voice services and the standalone ADSL service using the ULLS as an input. While it was never envisaged that the RKR would conclusively identify anti-competitive pricing behaviour, it is apparent that in a number of circumstances these tests do not materially inform the understanding of the competitive impact of Telstra’s wholesale and retail pricing.

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<sup>31</sup> ACCC, Assessing price squeezes for ADSL services, page 19

<sup>32</sup> *Ibid.* page 19

<sup>33</sup> The bundle of fixed-line voice services comprises local calls and line rental, domestic and international long distance and fixed-to-mobile calls. The core service inputs for the bundle of fixed-line voice services are the LCS and the PSTN-O/T.

The ACCC's current assessment of the replicability of Telstra's fixed telephony bundles is that they are likely to be replicable, as the key wholesale inputs to these bundles (local carriage services, plus PSTN OTA) are declared, and hence required to be made available. Further, dispute resolution processes support the negotiation of commercial terms. In those circumstances, it would appear reasonable for Telstra to perform its price equivalence imputation tests under the PEF across a bundle of retail line rental, local call, fixed-to-mobile and long distance services.

With regard to bundles of fixed voice services and ADSL services, the ACCC believes the increasing prevalence of bundling of these services in the retail market tends to support the view that such bundles are replicable. Further, such bundling is being encouraged by the increasing feasibility of using the more disaggregated inputs into such a bundle. For example, access seekers are increasingly using the ULLS in combination with declared transmission and PSTN TA services, in addition to using local carriage services in combination with PSTN OTA services and wholesale ADSL services where their networks are not yet built out. This perhaps indicates that imputation testing across the retail bundle of fixed voice and ADSL services (using both sets of inputs) may potentially be more relevant than an imputation test which focuses on the provision of ADSL services alone. Having said that, the ACCC notes that bundling strategies and the availability of key inputs may change. These issues may therefore require further consideration if there are specific complaints about anti-competitive pricing (including on the replicability of a bundle of ADSL and fixed voice services).

The ACCC notes that Telstra also bundles other services with fixed voice services, such as mobile services and pay TV (via a resale agreement with Foxtel). While some of Telstra's competitors do offer similar bundles, there is no evidence that suggests that such services are widely available for resale on commercial terms. Hence such bundles may not be replicable by competitors in a meaningful sense. This suggests that contributions from these services should be excluded from price equivalence imputation tests.

The ACCC considers that where bundles can be commercially and technically replicated by competitors, the standard imputation tests contained in Telstra's Retail Pricing Tool for the purpose of price equivalence should be implemented across the range of products that determine eligibility for the discount. However, where bundles cannot be replicated, a modified test (or stand-alone test) should be undertaken.

## 5 Reporting and transparency

The ACCC has given consideration to what information Telstra should report on in order to demonstrate price equivalence and also what information needs to be publicly disclosed in order to achieve transparency in relation to the supply of Telstra's wholesale services.

The Government outlined that one of the underlying principles of the PEF is that it 'should seek to simplify and make more transparent the relationship between Telstra's wholesale prices and the prices of its relevant retail services'.<sup>34</sup>

### 5.1 General reporting requirements

As set out in the Ministerial Determination and re-iterated in Telstra's OSP, the ACCC has the right to request information from Telstra relating to operational separation if it believes the information is necessary to enable it to do one or more of the following:

- monitor Telstra's implementation of the plan;
- investigate Telstra's compliance with the plan where the ACCC has received a complaint from one of Telstra's wholesale customers or where the ACCC has a reasonable basis to believe Telstra has breached, or may be in breach, of the plan;
- advise the Minister on Telstra's annual compliance report;
- advise the Minister on Telstra's independent audit report;
- provide advice to the Minister about any Telstra proposals to vary the final operational separation plan or a final rectification plan;
- assist in undertaking a review of the operational separation arrangements; or
- enforce any rectification plan that may be in place.<sup>35</sup>

In requesting information relating to operational separation, the ACCC must write to Telstra seeking its comments on the estimated cost of fulfilling the request to allow an assessment of whether the likely benefit accruing from this request is reasonable and proportionate to the cost.

The Minister requires Telstra to issue an annual compliance report which addresses any areas of material non-compliance with the OSP. Telstra's PEF strategy specifies that this report will include a summary of:

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<sup>34</sup> Explanatory Statement, Telecommunications Act 1997, Telecommunications (Requirements for Operational Separation Plan) Determination (No.1) 2005. Part 4 Clause 13.

<sup>35</sup> Telecommunications (Requirements for Operational Separation Plan) Determination (No. 1) 2005, Part 5, s19–21.

- a) Telstra's performance in meeting all of its obligations under the OSP, including in relation to the PEF strategy and the PEF generally;
- b) Any areas of non-compliance with the OSP and action taken to address the non-compliance including in relation to the PEF strategy and the PEF generally;
- c) Action taken by Telstra to address any systemic problems in relation to its obligations under the OSP; and
- d) Any matter arising out of the implementation or of compliance with the OSP that has impaired Telstra's ability to compete on a fair and efficient basis.<sup>36</sup>

## 5.2 Reporting to the ACCC and the public

In order to achieve the Government's stated objectives, the ACCC considers it would appear necessary that operational separation allow for:

- a structured and effective monitoring regime which allows the ACCC to assess Telstra's compliance with price equivalence; and
- a transparent public reporting process which provides third parties with confidence that Telstra is treating its competitors equivalently.

### 5.2.1 Reporting to the ACCC

Telstra has outlined in its PEF Strategy that it will provide the ACCC with the price equivalence imputation test results for each material price change proposal no later than four business days after customers have been generally advised of the price change by Telstra, or where the price change takes effect within four business days after customers are generally advised of the price change, on the day the price change takes effect.<sup>37</sup>

The ACCC considers that in order for the stated objectives of price equivalence to be fulfilled a reporting regime should be established under which Telstra:

- runs imputation tests in accordance with the principles in section 3 of this information paper *before* price changes are made;
- notifies the ACCC of the results of the imputation tests, a copy of working papers and underlying spreadsheets *at the same time* the public or third parties are notified of the price changes;
- publicly reports on the results of its imputation testing *after* implementing a price change;
- publicly reports the methodologies underlying the calculation of IWPs and the Retail Pricing Tool and notifies both the ACCC and the public when changes to these methodologies have been made.

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<sup>36</sup> Telstra, Price Equivalence Framework Strategy, 30 June 2005, page 7

<sup>37</sup> Telstra, Price Equivalence Framework Strategy, 30 June 2005, page 7

The ACCC considers that Telstra should provide it with the results of the price equivalence imputation tests using the template provided at Appendix 2.

As outlined in section 3, Telstra should only notify the ACCC of material price changes. The aim is to capture situations where there is the most potential for contravention of the TPA and the risk of the price changes leading to a substantial lessening of competition.

The ACCC also considers that Telstra should provide the ACCC with an up to date manual every six months (or more frequently where numerous changes have been made since last providing the ACCC with a copy of the manual) which explains the methodology and data sources which it is using to conduct its imputation tests and any underlying assumptions regarding the inputs to the imputation tests and any evidence which supports these assumptions.

The ACCC considers it appropriate that Telstra inform the ACCC of the results of its imputation testing at the same time it notifies the public or third parties of the price change. The ACCC considers that this approach to reporting price equivalence would give the ACCC the ability to analyse the *prima facie* effect of a price change as it occurs and would allow the ACCC to take action, if necessary, as soon as practicable after the price change is implemented. In addition, Telstra would be able to provide the ACCC with an understanding of reasons for contentious price changes at the time they occur.

An advantage of this reporting approach is that it will minimise the burden which would be placed on Telstra if it was to notify the ACCC of price changes on an *ex ante* basis and be required to prepare materials which demonstrate its compliance with price equivalence.

It is important to note that there is no formal approval process for price changes notified via price equivalence imputation tests. The ACCC would be able to indicate its concerns and seek further information from Telstra regarding specific price changes but would not be able to prohibit a price change except under the existing legal mechanisms available to it under the TPA. In addition, the ACCC would also not ordinarily be able to fully assess the impact of a price change without undertaking market inquiries.

### **5.2.2 Publication**

The ACCC notes that while the Ministerial Determination and Telstra's OSP empowers the ACCC to require Telstra to keep records and provide information to the ACCC, the ACCC has no power to either publish that information or to require Telstra to publish it. Further to this, Telstra's OSP and its PEF Strategy states that the results of imputation tests applied under the PEF will remain confidential and will not be disclosed to the public or its wholesale customers. Therefore, the ACCC is reliant on Telstra to make information produced for the purposes of demonstrating price equivalence publicly available.

Telstra has outlined in its PEF Strategy that it will produce quarterly reports for public release on its web site which will include information about each material price change proposal that has been notified to the ACCC.<sup>38</sup>

The ACCC considers that in general, the information obtained by the ACCC for the purposes of demonstrating price equivalence should be publicly disclosed to ensure the objective of transparency is achieved.

One argument against public disclosure is that publishing the imputation test results may allow Telstra's competitors to see exactly where they can price their retail services and / or allow them to compare the prices charged to them by Telstra with those charged to other competitors. However, the ACCC believes that given the highly aggregated nature of the information captured by the price equivalence imputation tests and the high level of aggregation these imputation tests are conducted at, the above argument is not a substantial concern.

In this context, the ACCC also notes that the level of aggregation proposed here is very similar to the imputation testing RKR's, which are already publicly disclosed. As such, the ACCC considers that notifying the public of the results of Telstra's price equivalence imputation tests after a price change has been implemented will not affect Telstra's ability to compete effectively or to price flexibly.

The ACCC envisages that in general no additional tests will need to be performed for the purposes of demonstrating available imputed margins, and that the publication of tests otherwise being performed under the PEF strategy will suffice.

Given the potential for imputed margins to alter in between price changes (such as due to changes in unit costs or changes in product mix), it may however be necessary to conduct an imputation test periodically where that test has not been performed recently. In this regard, Telstra should conduct a price equivalence imputation test and report the results to the ACCC where such a test has not been performed within the last six months for the purpose of providing transparency around equivalence in Telstra's pricing.

In the circumstance where Telstra is required to undertake price equivalence imputation test within three months of having conducted a six monthly test, the ACCC considers that Telstra would not have to refresh its unit cost data, but would have to update its retail price and IWP data, for the purposes of that test.

### **5.3 Harmonising public price equivalence reporting with enhanced accounting separation requirements**

Given the overlap between Telstra's obligations to conduct imputation test results under the PEF strategy and also under the current enhanced accounting separation arrangements, there is a potential to harmonise these obligations. This would see common methods used in conducting the tests performed under the respective arrangements.

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<sup>38</sup> Telstra, Price Equivalence Framework Strategy, 30 June 2005, page 7



Depending on the frequency of Telstra's price equivalence reporting in practice, consideration could also be given to reducing the frequency of enhanced accounting separation imputation tests to six-monthly intervals.

Further, provided that arrangements can be put in place such that Telstra would undertake a regular public reporting regime of imputation tests performed under the PEF strategy as outlined above, consideration could be given to discontinuing the enhanced accounting separation imputation tests altogether.

As the enhanced accounting separation arrangements were put in place at the direction of the Minister, any such initiatives would require further consultation and Ministerial approval.

## 6 Conclusion

The purpose of this protocol is to outline the ACCC's role in relation to the pricing aspects of the operational separation of Telstra, and how this role sits alongside its responsibilities under the TPA.

The principles expressed in this protocol provide guidance on how Telstra should demonstrate pricing equivalence for particular designated services. The ACCC has outlined its views on methodological and reporting issues for consideration in the development and implementation of Telstra's Retail Pricing Tool and described how the price equivalence imputation tests derived from the Retail Pricing Tool is likely to be approached by the ACCC in assessing allegations of price squeezes under Part XIB of the TPA.

The ACCC will carefully consider the interpretation of the results of a price equivalence imputation test undertaken using the principles outlined above. As noted above, various judgements have to be made on the treatment of key inputs to the test. Therefore, the ACCC believes it would be appropriate to consider the robustness of the base test result to different judgements, or different scenarios.

Where one or more of these tests result in a fail, or should the ACCC consider that sufficient concerns exist under Part XIB irrespective of the results of these tests, it will proceed to seek more information on the possible price squeeze, including its effect or likely effect on competition, including the factors identified in section 2.2.3. Whether the evidence then obtained is sufficient to provide the ACCC with a reason to believe that Telstra has engaged, or is engaging in anti-competitive conduct will depend on the circumstances of each case.

## Appendix 1 – Service definitions

**BigPond ADSL** – the supply of a retail residential internet service provided by Telstra on an asymmetrical digital subscriber line

**Domestic PSTN Originating Access Service** – an access service for the carriage of telephone (i.e. PSTN and PSTN equivalent such as voice from ISDN) calls (i.e. voice, data over the voice band) to a Point of Interconnection (POI) from end-customers assigned numbers from the geographic number ranges of the Australian Numbering Plan and directly connected to the Access Provider's network

**Domestic PSTN Terminating** – an access service for the carriage of telephone (i.e. PSTN and PSTN equivalent such as voice from ISDN) calls (i.e. voice, data over the voice band) from a POI to end-customer assigned numbers from the geographic number ranges of the Australian Numbering Plan and directly connected to the Access Provider's network.

**Domestic Transmission Capacity Service** – a service for the carriage of certain communications from one transmission point to another transmission point via network interfaces at a designated rate on a permanent basis by means of guided and/or unguided electromagnetic energy, except communications between:

1. one customer transmission point and another customer transmission point; and
2. a transmission point in an exempt capital city and a transmission point in another exempt capital city;
3. a transmission point in Sydney and a transmission point in any of the following regional centres: Albury, Lismore, Newcastle, Grafton, Wollongong, Taree and Dubbo;
4. a transmission point in Melbourne and a transmission point in any of the following regional centres: Ballarat, Bendigo, Geelong and Shepparton;
5. a transmission point in Brisbane and a transmission point in any of the following regional centres: Toowoomba and Gold Coast;
6. a transmission point in Adelaide and a transmission point in Murray Bridge; and
7. one access seeker network location and another access seeker network location.

**Fixed-to-mobile call** – a call involving the use by the calling party of a PSTN carriage service and the use by the called party of a mobile carriage service

**International long-distance call** – an operator-connected call between a place in Australia and a place outside of Australia; or a direct-dialled call between a place in Australia and a place outside of Australia

**Local call** – an eligible local call is defined by section 106 of the *Telecommunications (Customer Protection and Service Standards) Act 1999*

**Local Carriage Service** – a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone

**Line rental** – the ongoing supply of a Standard Telephone Service at a location required by the person requesting the supply of the service

**Line Sharing Service** – the use of the non-voiceband frequency spectrum of an unconditioned communications wire (over which wire an underlying voiceband PSTN service is operating) between the boundary of a telecommunications network at an end-user's premises and a point on a telecommunications network that is a potential POI located at, or associated with, a customer access module and located on the end-user side of the customer access module

**National long-distance call** – a call dialled directly by a caller and made from a charging zone in the domestic public switched telecommunications network to a telephone service in another charging zone that is not immediately adjacent to the first-mentioned charging zone.

**PSTN** – a public switched telephone network

**Relevant retail services** – Line rental and local calls, National long distance calls, International long-distance calls, Fixed-to-mobile calls, BigPond ADSL are relevant retail services for the purposes of price equivalence imputation testing. It should be noted that this definition may change from time to time.

**Standard Telephone Service** – (also known as a Basic Telephone Service) has its meaning given in the Telecommunications (Consumer Protection and Service Standards) Act 1999, and *includes*:

- (a) connection to a PSTN;
- (b) the ability to make and receive certain types of calls (subject to any conditions that might apply to particular types of calls);
- (c) a telephone number;
- (d) a free listing of the telephone number in a telephone directory; and
- (e) (to avoid doubt) line rental

**Unconditioned Local Loop Service** – a service for the use of unconditioned communications wire between the boundary of a telecommunications network at an end-user's premises and a point on a telecommunications network that is a potential point of interconnection located at or associated with a customer access module and located on the end-user side of the customer access module

**Wholesale ADSL Layer 2 Service** – a carriage service that uses:

- (a) asymmetric digital subscriber line access technology to transmit data from the boundary of a telecommunications network at an end-user's premises to an exchange (where the data is transmitted to and from the boundary of a telecommunications network at an end-user's premises by means of a communications wire at a minimum upstream peak speed of 64kbps and a minimum downstream peak speed of 256 kbps); and
- (b) layer 2 tunnelling protocol over a transport layer to aggregate data traffic at an exchange at which a point of interconnection is located.

## Appendix 2 – Example (Test 1) Reporting Template

		Component services										Bundled service		
		Line rental & local calls		National long distance		International calls		Fixed-to-mobile calls		BigPond ADSL		All services		
		Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Residential	Business	Total
Costs	<u>Retail costs</u>													
	Organisation													
	Product and consumer													
	<b>Total Retail costs</b>													
	<u>Other costs</u>													
	Organisation													
	Product and consumer													
	Network expenses													
	<b>Total Other costs</b>													
	<b>Ancillary costs</b>													
	<b>Cost of capital</b>													
	<b>TOTAL COST</b>													
	Unit cost													
Test 1														
IWP	<b>Domestic PSTN OA</b>													
	Revenues													
	Volumes													
	Yield													
	<b>Domestic PSTN TA</b>													
	Revenues													
	Volumes													
	Yield													
	<b>Local carriage service</b>													
	Revenues													
	Volumes													
	Yield													
	<b>Domestic tx capacity</b>													
	Revenues													
	Volumes													
	Yield													
Margin	Imputed margin \$													
	Imputed margin %													