

TELSTRA CORPORATION LIMITED

Fixed Line Services FAD inquiry on price and non-price terms and conditions

Submission on the application of the SAOs for WLR/LCS in CBD areas

13 October 2014

Public version

Table of Contents

Executive Summary.....	3
1. Introduction.....	7
1.1. Background.....	7
1.2. Framework for considering whether to limit the application of SAOs in FADs	8
2. An evidence-based review of market structure in CBD areas is required	11
3. Competition in CBD areas is effective.....	14
3.1. Alternative infrastructure providers.....	14
3.2. DSLAM-based competition	15
4. Prior ACCC arguments on competition in CBD areas	18
4.1. Voice only residential end-users.....	18
4.2. Small business end-users.....	19
4.3. Medium-sized business end-users.....	20
4.4. Large business end-users	20
4.5. Copper based voice only services in CBD areas	21
4.6. Competitive substitutes for supplying voice-only services in CBD areas.....	22
4.7. Retail prices in CBD areas.....	23
4.8. Corporate and Government end-users whole of business solution	23
4.9. Encouraging the economically efficient use of, and investment in, infrastructure.....	24
5. Applying the SAOs in respect of WLR and LCS in CBD areas.....	25
5.1. The Bottleneck Test.....	25
5.2. The DTCS test	26
5.3. Application of a graduated test to WLR and LCS in CBD areas	27
6. Conclusion.....	33
Appendix 1: Applicable case law	35
Appendix 2: Competition and share of supply on the Telstra fixed line network.....	37
Appendix 3: Sundakov Report.....	40

Executive Summary

Telstra provides this submission to the Australian Competition and Consumer Commission (**ACCC**) in response to the ACCC's consultations on the price and non-price terms of the new final access determinations (**FADs**) for the wholesale line rental service (**WLR**) and the local call service (**LCS**).

In making new FADs for WLR and LCS, the ACCC should provide that the standard access obligations (**SAOs**) are not applicable in CBD areas¹ unconditionally (**CBD SAO Exemption**). In the alternative, Telstra submits that ACCC should provide for the CBD SAO Exemption subject to appropriate conditions and limitations, to ensure that the SAOs only apply to the extent required to meet the statutory criteria.

Regulation, where effective competition exists, risks distorting the market and would not be in the long term interests of end users (**LTIE**). Facilities-based competition has a number of advantages over regulated resale access as it results in greater price competition, service innovation and competition over a broader range of product attributes. Ensuring that CBD ESAs are not subject to unnecessary resale regulation (by setting aside the application of the SAOs in these areas) can ensure a continuation and promotion of facilities-based competition given the extensive rollout of infrastructure and the existence of effective competition. Re-instatement of the longstanding voice resale exemptions in CBD areas will promote ongoing infrastructure based competition and investment in CBD areas and will facilitate further product innovation, better services, and differentiated choices for consumers.

The statutory criteria require the ACCC to consider the application of the SAOs in the making of a new FAD as a new decision. However, Telstra is mindful that the ACCC may seek to rely on its analysis in its most recent final decision on the declaration of WLR and LCS with CBD areas. In Telstra's view, the ACCC erred in its final decision, with undue weight being placed on the price Telstra has charged for WLR (and the relationship between the output of its utility pricing model and this in-market price) rather than actual competitive market dynamics.

This submission addresses three key issues:

- The ACCC's decision to impose regulation in CBD areas focussed incorrectly on the fact that Telstra's long-standing commercial prices for the WLR and LCS services (that had not increased since 2005) were different to regulated rates that had recently been set by the ACCC in other areas. Further, the analysis the ACCC undertook in assessing the potential impact of commercial pricing was flawed.
- In determining to regulate access to WLR and LCS services in CBD areas for the first time since 2002, the ACCC has given insufficient weight to more than a decade of commercial supply, competitive investment and clearly competitive outcomes in CBD areas.
- Any reasonable assessment of the competitive conditions within CBD areas clearly shows that it is not in the LTIE to apply the SAOs for WLR and LCS in these areas.

In determining to regulate prices for WLR and LCS services in CBD areas, the ACCC has focussed on a comparison with regulated prices rather than an assessment of market conditions

The primary basis for the ACCC's view in the declaration inquiry that Telstra retained market power in CBD areas was its analysis of the difference between the prevailing market price for WLR in CBD areas and the regulated price the ACCC had determined in the 2011 FAD. Rather than adjusting its prices to reflect the ACCC's changed approach to regulation, Telstra had maintained its long-standing prices for WLR and LCS in CBD areas.

¹ For the purposes of this submission, "CBD areas" refers to CBD exchange service areas (**ESAs**) of Sydney, Melbourne, Brisbane, Adelaide and Perth.

In Telstra's view, the ACCC's decision rests primarily on the irrelevant consideration of comparing long-standing market prices to the outcome of a particular regulatory pricing approach. Telstra has commissioned an expert report from Mr Alex Sundakov to consider whether using a utility pricing model, as used by the ACCC, provides a useful approximation of pricing outcomes from a workable competitive market (refer to Appendix 3). The report clearly demonstrates that no inference as to the state of competition can be drawn from market prices that diverge from the outcomes of a utility pricing model. Moreover, Mr Sundakov observes that market evidence indicates that the price charged by Telstra for wholesale services in CBD areas has in fact been below the level that would induce competitive entry.

In effect, rather than evaluate real evidence of market behaviour and structures, the ACCC has determined what it thinks should be the competitive market outcome by reference its building block cost model, and drawn a conclusion that competition is not effective wherever that outcome is not observed. In short, rather than undertake a genuine market review and competition analysis, the ACCC has sought to "bootstrap" its analysis to the output of a utility pricing model. In doing so, the ACCC fails to acknowledge that a BBM model is used as a **remedy** for, and not a **measure** of, market power.

In addition, the ACCC:

- drew many of its conclusions from "edge" cases rather than taking a holistic view of market dynamics; for example, its analysis of residential customers was based on Telstra's low line rental / high calling cost HomeLine Budget product designed for low income earners of which there are very low numbers in CBD areas;
- did not consider that voice telephony is supplied as a bundle of calling and access lines or that WDSL is an insignificant means by which broadband is supplied to small business customers compared with LSS/ULLS;
- assumed uniform telecommunications needs for all business customers across CBD areas, based on the needs of a small retail outlet;
- dismissed the emerging use of IP telephony and mobile substitution by business and residential customers;
- erred by focussing on margin protection for competitors rather than on the process of competition itself;
- failed to consider the negative effects on the investment incentives for infrastructure within CBD areas from the re-regulation of WLR and LCS;
- erred by giving insufficient weight to over a decade of infrastructure investment made by network operators in CBD areas which was promoted by the ACCC's earlier decision to grant exemptions for resale services in these areas; and
- on the basis of an unsubstantiated case study and without further analysis, ascribed competitive effects in the substantial markets for large corporate and government customers and investment in infrastructure outside CBD areas.

In order for regulation of a service to be in the LTIE, it must be demonstrated that the service responds to a market 'bottleneck'. This requires the ACCC to undertake careful analysis of market structure and conduct – work which cannot be avoided by referring instead to the outputs of a building block cost model.

Ongoing competitive investment means competition is now more effective in CBD areas than at any at any other time

Prior to the ACCC's most recent declaration decision in 2014, LCS had been excluded by the ACCC from declaration in CBD areas since 2002 and since WLR was first declared in 2006, this service had not been regulated in CBD areas. Regulatory forbearance in CBD areas has been one of the key enablers of the competitive market for the supply of fixed line voice and broadband services in CBD areas. In the absence of regulated resale pricing, Telstra has maintained commercial supply of resale services and other service providers have continued to invest in competitive infrastructure and continued to develop new and innovative offerings which ultimately have benefitted end users.

Since the ACCC first removed CBD resale price regulation in 2002:

- Telstra has supplied WLR and LCS services in CBD areas on commercial terms in the absence of any regulated requirement to do so. Since December 2005, Telstra has maintained the price of these services (which were based on the previously regulated retail minus rates for WLR and LCS in non-CBD areas), meaning prices had decreased in real terms over that period;
- CBD areas have been subject to ongoing competitive entry. All 16 CBD ESAs have between 6 and 11 fibre providers and [REDACTED] DSLAM based competitors;
- strong infrastructure-based and ULLS-based competition has resulted in a decline in the use of Telstra's retail line rental and WLR in CBD areas at levels above the national decline in the past three years ([REDACTED]) while ULLS use increased over the same period by [REDACTED];
- the decline in use of Telstra's retail line rental and WLR is understated when PSTN numbers are juxtaposed against significant expansion of office space in CBD areas which illustrates significant by-passing of Telstra's network by fibre based and other competitive infrastructure providers.

End users in CBD areas enjoy the benefits of extensive competition which manifests in multiple choices as regards competitive service providers, network technologies, and product and service differentiation. The relatively high proportion of business premises in CBD ESAs has encouraged network operators to invest extensively in deploying their own infrastructure in order to compete for these high value business customers in the provision of voice and data services. This competitive infrastructure in turn benefits all end users through greater choice. Re-instatement of the longstanding voice resale exemptions in CBD areas will continue to promote the high levels of infrastructure based competition and investment which has occurred in CBD areas for more than a decade. This will also facilitate further product innovation, better services, and differentiated choices for consumers.

On any reasonable assessment, the SAOs should not apply to WLR and LCS services in CBD areas

Only services which constitute an enduring bottleneck should be subject to ex-ante regulation, which is clearly not the case with WLR and LCS in CBD areas. However, the ACCC has not sought to apply that test in its recent decisions, with a more conservative approach applied by the ACCC in its decision on the declaration of the Domestic Transmission Capacity Service (DTCS) which sought to balance access to services against providing the correct incentives for efficient investment through the removal of regulation. An examination of the approach used in the DTCS decision in the context of WLR and LCS in CBS areas again leads to a conclusion that an unconditional CBD SAO Exemption is appropriate, even considering the prices that Telstra had been charging for those services while they were unregulated.

The facts of the operation of the market are clear and no matter which prism the statutory criteria is applied to, whether through an enduring bottleneck test or some other formulation, the conclusion has to be that the market is competitive and further forbearance is required to further encourage and incentivise investment in alternative infrastructure. To do otherwise would not promote competition in the market but would likely distort it and risk undermining the substantial benefits that have been delivered to consumers in CBDs for over a decade by infrastructure based competition.

1. Introduction

Telstra welcomes the opportunity to make this further submission to the ACCC in response to its Position Paper on non price terms and conditions and supplementary prices and Discussion Paper on primary prices for the fixed line services.

1.1. Background

The ACCC has long recognised that there is effective competition in the supply of fixed line services (specifically in relation to WLR/LCS) in CBD ESAs. In July 2002, the ACCC granted geographic exemptions in relation to the supply of LCS in the CBD ESAs. As noted in its Final Decision, the ACCC considered:

"there is sufficient alternative infrastructure (such as fibre loops) and declared services (...[including] ULLS) for originating local calls in CBD areas either being used or can readily [sic] be used by alternative carriers and carriage service providers. The presence of such alternative infrastructure and services is believed to be adequate to serve as substitutes to the Local Carriage Service and act as a constraint on the Local Carriage Service Price that Telstra could charge..."

"the availability of the Local Carriage Service is preventing these infrastructure and services from being used more extensively to originate calls than is the case at present. This is on the basis that the Local Carriage Service provides an easier means of entry into market with minimal investment. ... granting of an exemption would serve to encourage greater use of these alternative infrastructure for originating local calls and encourage greater investment in infrastructure associated with other declared services. This should in turn lead to increased efforts by access seekers to connect customers by these means, leading to greater service diversity and price competition which would be in the long-term interest of end-users of local call services."²

In 2006, the CBD carve-out was applied to the WLR service when it was first declared (with CBD ESAs not being subject to the declaration). In its Local Services Review 2006 – Final Decision, the ACCC (based on the 2002 decision) determined that the relevant markets for LCS and WLR should be seen as national markets but excluding the CBD ESAs³. In 2009, the ACCC declared six fixed line services under section 152AL of the Competition and Consumer Act 2010 (Cth) (**the Act**). This included declarations for WLR and LCS.⁴ However, the service descriptions for LCS and WLR did not include services where the supply of the local carriage service originated from an exchange located within CBD areas of Sydney, Melbourne, Brisbane, Adelaide or Perth⁵.

As the services that were declared in 2009 were due to expire on 31 July 2014, on 11 July 2013 the ACCC commenced a public inquiry to determine whether the existing declarations should be extended, revoked, varied, allowed to expire or re-made.

On 17 April 2014, the ACCC published its final report on the declaration inquiry. It made the decision to extend the declaration of each of the six fixed line services for a further five year period, until 31 July 2019, as well as making a number of variations to the existing service descriptions. In this report, the ACCC outlined its decision to declare WLR and LCS in CBD areas.

² ACCC, Future scope of the Local Carriage Service, Final Decision, July 2002, p 64.

³ ACCC, Local Services Review 2006 – Final Decision, July 2006, p 3.

⁴ ACCC, Fixed Services Review Declaration Inquiry for the ULLS, LSS, PSTN OA, PSTN TA, LCS and WLR - Final Decision, July 2009, pp. 134-5

⁵ Note: the ACCC also reviewed competitive conditions in CBDs in granting PSTN OA exemptions in those areas in 2008 (consistent with the 2002 and 2006 LCS/WLR exemptions in those areas). This position was also confirmed by the Australian Competition Tribunal on Appeal in 2009 – refer <https://www.accc.gov.au/media-release/tribunal-grants-exemptions-for-wholesale-voice-services>.

The FADs that applied to the declared fixed line services were also due to expire - on 30 June 2014. On 16 April 2014 the ACCC extended those existing FADs for the fixed line services until the day before new FADs are made.

On 17 April 2014, the ACCC commenced a public inquiry into varying the newly extended FADs for four of the fixed line services, including WLR and LCS. On 18 June 2014, the ACCC varied the fixed line services FADs by, amongst other things, specifying price and non-price terms for the supply of the LCS and WLR service in CBD areas. These variations commenced on 1 August 2014.

The ACCC commenced a consultation on non-price terms and conditions and supplementary prices for new FADs for the fixed line services in May 2014 and a consultation on primary prices on 24 July 2014. This submission is in response to those consultations.

Through its recent decisions between April and June 2014 the ACCC reversed its long held positions with respect to declaration of WLR and LCS in CBD areas. In Telstra's view, the ACCC erred in these decisions. The ACCC appears to have placed undue weight on the price Telstra charged for supply of unregulated WLR in CBD areas and the fact that this price differed from the regulated price in other areas, rather than taking a holistic view of competition and market dynamics within CBD areas.

The current statutory regime does not provide a carrier or carriage service provider with an avenue to challenge the merit of those decisions. Nevertheless, Telstra has raised its position with the ACCC throughout the consultation processes in respect of the declaration inquiry and the subsequent application of the price and non-price terms of the existing SAOs to WLR/LCS from 1 August 2014.

Telstra continues to be of the view, that the continuing or unconditional application of the SAOs to WLR and LCS in CBD areas does not meet the statutory criteria the ACCC is required to apply in making the new FADs.

A FAD may provide that any or all of the SAOs are not applicable to a carrier or carriage service provider either unconditionally or subject to such conditions and limitations as are specified in the determination (paragraph 152BC(3)(h)).

Telstra submits to the ACCC that, in making new FADs for WLR and LCS, the ACCC should provide for CBD SAO Exemptions unconditionally. Telstra's alternative submission is that the ACCC should provide for the CBD SAO Exemptions to be subject to additional conditions and limitations, to ensure that the SAOs only apply to the extent required to meet the statutory criteria.

1.2. Framework for considering whether to limit the application of SAOs in FADs

The ACCC is required to take a number of matters into account when making a FAD as required by s152BCA of the Act. Particularly relevant to the consideration of whether the FAD will promote the LTIE is the question of whether it is necessary for the FAD terms and conditions⁶ to equally apply to the provision of declared services in all geographic areas, given that there are differences in the levels of competition and investment in geographic areas for the declared fixed services. In this regard, section 152BC(3) states that an access determination may provide that any or all of the SAOs are not applicable to an access provider, either unconditionally or subject to specified conditions and limitations.

In making a FAD, the ACCC must take into account a number of factors, including:⁷

- whether the determination will promote the LTIE;

⁶ References in this submission to the FADs, and terms and conditions in the FADs, encompass both the price and the non-price terms and conditions in the FADs for the fixed line services.

⁷ Section 152BCA

- the legitimate business interests of the access provider;
- the interests of all persons who have a right to use the declared service;
- the economically efficient operation of a carriage service, a telecommunications network or facility.

Section 152AB provides that in determining whether something promotes the LTIE, regard must be had to whether the thing is likely to result in the achievement of the following three objectives:

- Achieving any-to-any connectivity in relation to carriage services that involve communication between end-users: paragraph 152AB(2)(d).
- Promoting competition in markets for carriage services and services provided by means of carriage services: paragraph 152AB(2)(c) (**competition objective**). In determining the extent to which the competition objective is likely to be promoted, regard must be had to the extent to which the thing will remove obstacles to end-users of listed services gaining access to listed services (para 152AB(4)).
- Encouraging economically efficient use of, and investment, in the infrastructure by which carriage services and services provided by means of carriage services are supplied, are capable of being supplied or are likely to become capable of being supplied: paragraph 152AB(2)(e) (**investment objective**). In determining the extent to which the investment objective is likely to be promoted, regard must be had to:⁸
 - whether it is, or is likely to become, technically feasible for the services to be supplied and charged for, having regard to:
 - the technology that is in use, available or likely to become available; and
 - whether the costs that would be involved in supplying, and charging for the services are reasonable or likely to become reasonable; and
 - the effects, or likely effects, that supplying, and charging for, the services would have on the operation or performance of telecommunications networks;
 - the legitimate commercial interest of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope; and
 - incentives for investment in infrastructure by which services are supplied and any other infrastructure by which services are, or are likely to become, capable of being supplied.

The Full Court of the Federal Court has confirmed that each of the three objectives underpinning the LTIE is a mandatory relevant consideration in its own right.⁹ In relation to investment, Rares J observed in *Telstra Corporation Limited v ACCC*¹⁰ that competition cannot be promoted, and thus the LTIE may not be attained, if infrastructure investment is not economically feasible for an efficient service provider to make or support.

In Telstra's view, the statutory criteria that the ACCC must follow in making a FAD are clear. The ACCC must “**in making**” an access determination take into account the matters outlined in section 152BCA. The ACCC is not at liberty to rely on prior decisions and conclusions it made in relation to other processes such as those in relation to a prior FAD or declaration determination.

As those prior processes and determinations were conducted recently, Telstra will in this submission address the arguments put forward by the ACCC in favour of the declaration of, and

⁸ Para 152AB(6)

⁹ *Telstra Corporation Limited v Australian Competition Tribunal* [2009] FCAFC 23. See in particular at [260-270] per the Court.

¹⁰ [2008] FCA 1758, referring to the equivalent provisions in the Trade Practices Act 1974 (Cth).

application of the SAOs to WLR and LCS in CBD areas. However, this should not be an indication to the ACCC that it can merely rely on its previous reasoning without turning its mind to the questions afresh in its current process in making a new FAD.

The Full Federal Court (Jacobson, Lander and Foster JJ) in *Telstra v Australian Competition Tribunal* [2009] FCAFC 23 made a number of observations on certain aspects of the statutory criteria set out above. They included the Court's views on repealed section 152AT(5) of the Act which provided that an order by the ACCC in respect of an exemption application "*may be unconditional or subject to such conditions or limitations as are specified in the order*". Similarly, section 152BC(3)(h) provides that an access determination may provide that the SAOs are not applicable to a carrier either unconditionally or subject to such conditions or limitations as are specified in the determination. In Telstra's view, their Honours' decision on the application of section 152AT(5) as set out below is directly applicable to the construction of paragraph 152BC(3)(h):

"289. ... We reject the suggestion implied in the Tribunal's reasons that it is appropriate to proceed on a two stage basis: first, by determining whether it is satisfied that an order exempting would promote the LTIE; and secondly, if so satisfied, whether it is of the opinion that it ought to impose conditions or limitations.

290. We think the question of conditions or limitations must be approached at the same time as the ACCC (or the Tribunal on review) is considering whether it is satisfied that an order exempting will promote the LTIE. If it were otherwise and the two stage process were appropriate, then, of course, it would rarely be the case that any conditions or limitations would be imposed because the decision maker would have already reached the conclusion that the order which has been sought should be made because it would promote the LTIE. That would leave s 152AT(5) with little work to do.

292. ... the Tribunal asked itself the wrong question. The question that the Tribunal should have asked itself is whether it was satisfied that an order should be made exempting Telstra from its obligations under s 152AR(3) of the TPA subject to whatever conditions or limitations were appropriate that would promote the LTIE."

Further observations by the Full Federal Court on the statutory criteria are set out at Appendix 1.

Given the difficulties identified with the analysis undertaken by the ACCC to date in respect of the CBD exemptions, Telstra submits that any reasonable approach to applying the LTIE in the context of the current FAD process requires the ACCC to re-examine the issue. Telstra submits that the ACCC should undertake a complete and conventional market analysis to determine under section 152BC(h) whether the standard access obligations should apply to Telstra in these areas, taking into account the updated market evidence set out in this submission.

2. An evidence-based review of market structure in CBD areas is required

The ACCC must conduct a genuine, evidence-based market review in CBD areas. Simply making a ‘bootstraps’ argument based on the difference between a historic WLR price and the current BBM-based regulated price is not sustainable.

The primary basis for the ACCC’s view in the FLS declaration inquiry that Telstra retained market power in CBD areas was its analysis of the difference between the prevailing market price for WLR in CBD areas and the regulated price the ACCC had determined in the 2011 FAD.

In its Final Report, the ACCC stated (referring to its draft report):¹¹

“...the ACCC has received evidence during this inquiry that Telstra is charging prices for the WLR service in the exempt CBD areas that are significantly higher than the regulated WLR price. Specifically, Telstra’s list price for a business WLR service (Basic Telephone Service with Business Access) is \$31.77 per month compared to the regulated price of \$22.84 per month. The draft report considered this evidence supported a conclusion that Telstra has market power in the exempt areas and is using that market power to set above-cost WLR prices.”

Telstra submits that the ACCC provided little, if any, other substantive evidence to support its finding of market power in these areas.

The ACCC maintained this position in its Final Report, and consequently determined that it would be in the LTIE to remove the CBD exemptions for LCS and WLR. The ACCC subsequently decided to vary the existing FADs for WLR and LCS, to extend the application of regulated pricing to CBD areas. The ACCC considered that to do so would be in the LTIE, because in the absence of regulated prices for LCS and WLR service in CBD areas, Telstra would be expected to charge (at least in the case of the WLR service) prices that are above efficient costs. The ACCC also asserted that “it would also be open to Telstra to charge LCS prices above the efficient costs [sic]”, even though there was no evidence of Telstra having in fact done so.¹²

The ACCC’s reasoning is deeply flawed and cannot be sustained. The mere fact that Telstra’s pricing of WLR in CBD areas does not match the output of the ACCC’s building block cost model cannot be taken as evidence of market power, in and of itself. That is to say, a BBM price may be the final outcome of a proper market enquiry (if market power is found to exist), but it simply cannot be used as a shortcut to avoid undertaking a proper enquiry at all.

In effect, rather than evaluate real evidence of market behaviour and structures, the ACCC has determined what it thinks should be the competitive market outcome by reference its building block cost model, and drawn a conclusion that competition is not effective wherever that outcome is not observed. In short, rather than undertake a genuine market review and competition analysis, the ACCC has sought to “bootstrap” its analysis to the output of a utility pricing model. In doing so, the ACCC fails to acknowledge that a BBM model is used as a **remedy** for, and not a **measure** of, market power.

The LTIE requires a very different and evidence-based approach. In order for regulation of a service to be in the LTIE, it must be demonstrated that the service responds to a market ‘bottleneck’. This requires the ACCC to undertake careful analysis of market structure and conduct – work which cannot be avoided by referring instead to the outputs of a building block cost model. Only once it has been determined that regulation is warranted based on market evidence will there be a need for application of the building block model to determine a regulated price.

¹¹ ACCC, *Public Inquiry into the fixed line services declarations: Final Report*, p 35.

¹² ACCC, *Fixed Services Review – Extension of existing fixed line services and wholesale ADSL final access determinations – Inquiry into varying the WLR, LCS, ULLS and LSS final access determinations: Discussion Paper*, April 2014, p 17.

As the ACCC is aware, building block cost models rely on many assumptions about how costs are calculated and recovered over time through prices, which may or may not reflect the way prices are determined in a competitive market. These include:

- **Valuation of assets.** In many utility pricing models (including the model relied on by the ACCC), an initial asset valuation is 'locked in' and then rolled forward based on new capital expenditure, asset disposals and depreciation. In the ACCC pricing model, the initial asset valuation was based on historic cost, with explicit adjustments designed to deliver a particular regulated price outcome for the ULLS. It is very unlikely that this is how assets would be valued when considering prices needed to recover costs in a competitive market.
- **Risk reflected in the cost of capital.** The return on capital in utility pricing models is intended to reflect the risk faced by the business in supplying regulated services. The risk profile of a regulated business may well be different to the risk profile of a firm operating in a competitive market, and therefore the required return on capital may be different for these two types of businesses.
- **Timing of cost of capital reset.** In utility pricing models, it is assumed that the cost of capital is effectively reset each time prices are reviewed. One implication of this is that regulated prices may rise or fall as a result of changes in the prevailing cost of capital between resets. However this is unlikely to reflect the timing of changes to the cost of capital for firms in competitive markets – for example, competitive firms may refinance debt at more regular intervals, in order to hedge against refinancing risk.
- **Timing of capital cost recovery.** Utility pricing models employ certain assumptions about the timing of capital cost recovery, which may or may not match how competitive firms seek to recover capital costs over time. A common assumption of utility pricing models is that depreciation is recovered evenly over the economic life of the relevant assets.

Given this, there it cannot be assumed that the output of a building block cost model will generally indicate the price that should (or would) prevail in a competitive market at any point in time.

This conclusion is made by Mr Alex Sundakov in his expert report, annexed to this submission (Appendix 3). Mr Sundakov states:¹³

"In networks which have high sunk costs, utility pricing models provide weak indications of pricing outcomes from a workably competitive market. Regulated prices derived from such cost-of-service models cannot be legitimately used as a proxy for competitive market prices."

The ACCC's reliance on outputs of its utility pricing model as a measure of competition is particularly inappropriate in this case, given its recent change in pricing methodology for regulated services. In 2011, the ACCC changed from a retail-minus pricing methodology for WLR, to a building block method. This change in methodology resulted in a significant reduction in the regulated price for WLR, from \$25.57 to \$22.10 (with a subsequent increase to \$22.84).

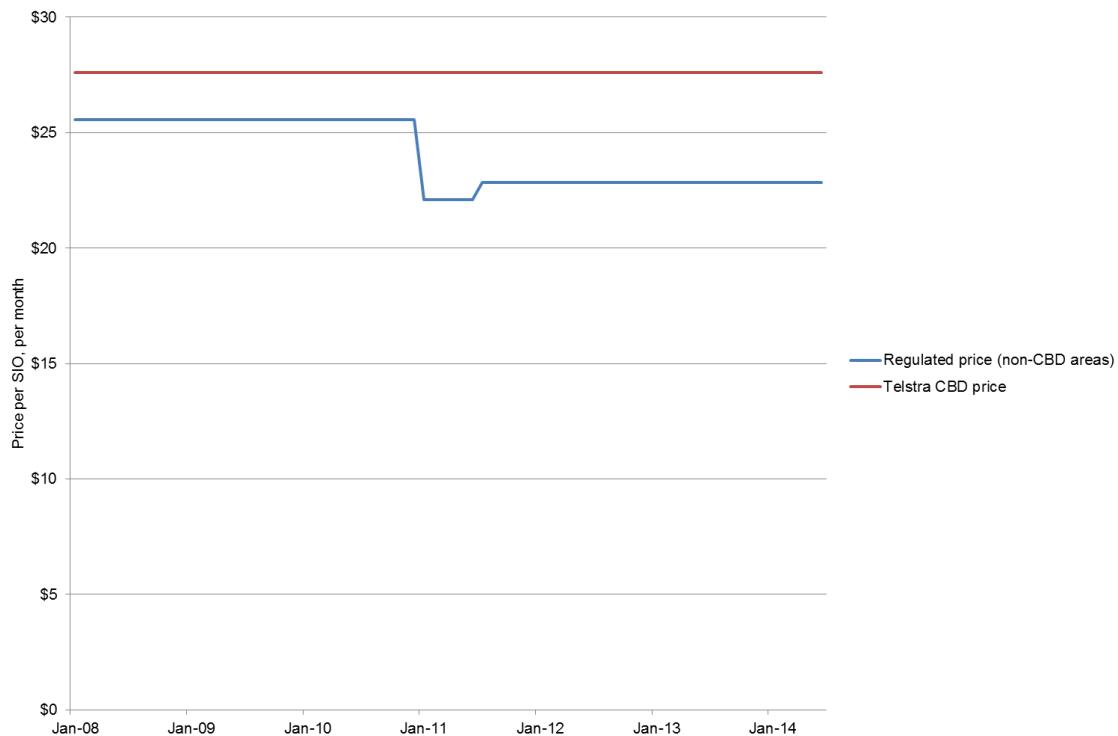
The ACCC appears to have expected that Telstra should have changed its pricing for WLR in CBD areas at the time the ACCC changed its methodology for determining the WLR price outside CBD areas. However clearly this is not how a firm operating in a competitive market would be expected to behave. Instead, in the face of ongoing constraint from ULLS-based and facilities-based competitors, Telstra has maintained the same pricing for WLR and LCS in CBD areas for nearly a decade (meaning that in real terms, prices for these services have fallen over time).

The difference between the WLR price in CBD areas and the regulated price in other areas between 2011 and 2014 was not due to any change in pricing by Telstra in CBD areas. Rather,

¹³ Sundakov Report, p 1.

this was principally due to the ACCC changing its pricing methodology. This is shown in Figure 1 below.

Figure 1: Telstra CBD pricing for WLR, compared to ACCC regulated price



The evidence principally relied upon by the ACCC in the FSR process (and the subsequent variation and extension) is flawed and unsustainable. The ACCC cannot avoid undertaking a genuine and substantive review of the market dynamics in CBDs simply by trying to rely upon the difference between Telstra's WLR pricing in these areas and the regulated BBM-based price.

The mere fact that Telstra did not follow the regulated price downwards in 2011 when the ACCC methodology changed does indicate anything about competitive conditions in CBD areas.

For these reasons, it is necessary and appropriate for the ACCC to now consider under paragraph 152BC(h) whether the SAOs should apply in CBD areas, taking into account a proper and evidenced-based analysis of market dynamics in those areas.

The rest of this submission provides further updated evidence to assist the ACCC with this important task.

3. Competition in CBD areas is effective

Competition is effective in CBD areas and has been for a long period of time, as recognised by the ACCC's decision to exclude LCS from regulation in CBD areas as far back as 2002 (reaffirmed by the ACCC in at least 3 subsequent review processes in 2006; 2008¹⁴ and 2009). Since then, competition in CBD areas has only increased.

Unlike most other areas, competition in CBD areas arises from firms competing *with* the Telstra fixed line network (by deploying their own fibre-based access networks) as well as, the more usual, competition *on* the network - where access seekers make use of DSLAM-based infrastructure and ULLS and LSS services to compete with Telstra supplied retail and resale voice and broadband services.

The following examines the level of competition from alternative infrastructure providers, DLSAM based infrastructure providers and the recent competitive dynamic over the copper based network. Further detail on competition within CBD areas is contained in Appendix 2.

3.1. Alternative infrastructure providers

There are multiple alternative infrastructure providers in the CBD areas – including fibre and wireless providers – enabling competitive provision of services to end users whilst completely avoiding using Telstra's infrastructure.

Competitive fibre networks facilitate end to end infrastructure based competition across the complete range of fixed line telecommunication services and provide the maximum opportunity for competition through price, service offering and differentiation. Competitive IP-based voice services operate as full substitutes to traditional PSTN voice services including WLR and LCS in CBD areas.

The ACCC has published data it has collected as part of its Infrastructure Record Keeping Rule identifying ESAs with two or more fibre providers. All 16 CBD ESAs are included with data as at September 2013 showing two CBD ESAs with 6 fibre providers, four CBD ESAs with seven fibre providers; five CBD ESAs with eight fibre providers; one CBD ESA with 10 fibre providers and four CBD ESAs with 11 fibre providers (all including Telstra).¹⁵

The ACCC has recently completed an investigation into TPG's plans to extend existing fibre networks that it owns in Adelaide, Brisbane, Melbourne, Perth and Sydney to large apartment buildings to serve with VDSL 500,000 premises. The ACCC noted that it had "carefully examined TPG's plans" and that its networks "were capable of supplying superfast carriage services to small business or residential customers at 1 January 2011, and confirmation that TPG is not extending the footprint of these networks by more than one kilometre."¹⁶ This careful examination of TPG's plans should have provided the ACCC with a detailed overview of the size and scale of TPG's fibre based assets within the CBD ESAs. Moreover, TPG is proceeding with these plans to further utilise its fibre assets in the provision of voice and broadband services to small business and residential customers.

In addition to competitive fibre suppliers, Telstra supplies fibre-based DTCS tails to CBD premises. Starting at 2Mbps, these services can supply multiple voice channels using protocols ranging from SIP trunks through to ISDN emulation. This means that there are also regulated fibre alternatives (DTCS) in CBD areas.

As well as fibre-based networks, fixed wireless has become a viable alternative for the supply of voice services¹⁷ and mobile provider, Vodafone has announced its plans to begin offering Voice

¹⁴ In relation to PSTN OA services in CBD areas.

¹⁵ ACCC, Infrastructure RKR, Published October 2013 (Data as at September 2013)

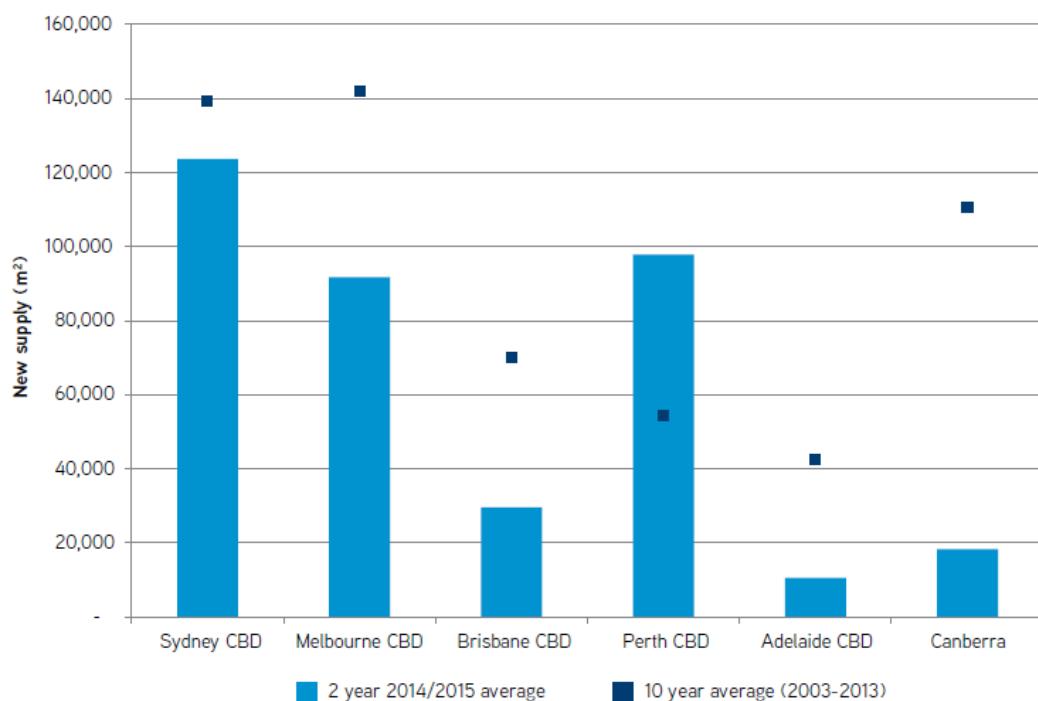
¹⁶ <http://www.accc.gov.au/media-release/accc-not-to-take-action-to-block-tpgs-fibre-to-the-basement-network-rollout>

¹⁷ For example; Big Air markets its wireless Ethernet service as being superior to ADSL for supporting VoIP and video applications (including telepresence applications) see

over LTE next year.¹⁸ Their recent marketing positions this network as offering speeds faster than ADSL2+ showcasing that it is also a substitute for the supply of voice and broadband services.

Figure 2 below shows the average annual growth in office space in CBD areas over the 10 years from 2003 to 2013.¹⁹ This would indicate an approximate average of an additional 450,000m² of office space per annum across the CBD ESAs, or over 3,000,000m² over the past 7 years. However, over the seven years from September 2007 to June 2014, PSTN voice SIOs in Band 1 (WLR and retail basic access) declined by [REDACTED]. This illustrates that during the period since 2002 while WLR and LCS have been exempt from regulation in CBD areas there has been significant expansive use of alternative infrastructure to provide voice services to the significant amount of new office space in CBD areas.

Figure 2: Average annual growth in office space in CBD areas from 2003 to 2013



Source: Colliers International

3.2. DSLAM-based competition

In addition to the significant prevalence of competitive fibre infrastructure within CBD areas, competitors have also invested in ULLS based infrastructure competition. Namely, DSLAMs and related infrastructure that make use of the ULLS in order to access the PSTN access network

http://www.bigair.com.au/applications/voice_and_video; NVD promotes voice using fixed wireless as a substitute to fixed line connections, see <http://nvdgroup.com.au/Fixed-Wireless.html>; Cirrus Comms supports VoIP through fixed wireless. Its website states: "Cirrus wireless has been built to deliver commercial grade broadband services. The network will support data hosting, video conferencing, surveillance and security applications, offices with more than 20 staff, multimedia content delivery, multi-sites virtual private network (VPN) and more" and "Your subscriber unit is extremely powerful, supporting bandwidths of many Mbps – faster than almost all standard ADSL and cable wired technologies. Furthermore, the wireless links are intrinsically symmetrical and can offer fast uploads as well as downloads", see <http://cirruscomms.com.au/support/general-faqs#faqnoanchor>.

¹⁸ <http://www.gizmodo.com.au/2014/08/vodafone-will-launch-voice-over-lte-next-year/>. See as an example Parramatta Advertiser, 4 June 2014, Vodafone Ad, '4Get Home Broadband, our 4G is even faster'

¹⁹ Colliers International, Research and Forecast Report, Second Half 2014, Australia and New Zealand, CBD Office, Leading the charge, IT&T change the face of tenant demand, page 10.

(bypassing the need for access seekers to acquire WLR/LCS or other Telstra-supplied access services).

DSLAM-based infrastructure²⁰ is a key enabler of competitive alternatives to Telstra-supplied PSTN voice and Telstra-supplied DSL services at both the retail and wholesale level. DSLAM-based infrastructure can provide both voice and broadband services in competition with Telstra's own services. Aside from the technical capabilities of DSLAMs, their importance as a competitive constraint arises from the relatively low cost at which they can be deployed. The economics of DSLAM-based infrastructure are such that there are no material barriers to entry and expansion of competition in the CBD ESAs.

There is overwhelming evidence of DSLAM-based supply within CBD areas and its impact on competition. As at June 2014 there are [REDACTED] DSLAM-based competitors in CBD ESAs, compared to [REDACTED] DSLAM-based competitors in the Band 2 ESAs.²¹ There is [REDACTED] between seven and ten DSLAM-based access seekers within each of the CBD ESAs. [REDACTED]
[REDACTED]
[REDACTED]

The concentration of investment in DSLAM-based infrastructure within CBD ESAs can best be shown by examining the capacity access seekers have installed within Telstra's exchanges. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

CBD ESAs contain a significantly larger addressable market than other ESAs. On average CBD ESAs are approximately 37% larger in terms of active PSTN (including ULLS) SIOs than Band 2 ESAs ([REDACTED]).

The number of active PSTN SIOs (not including ULLS) in CBD ESAs ranges from [REDACTED].²² It should be noted that the significant presence of alternative, fibre-based networks within CBD ESAs means that these data underestimate the true size of the addressable market – particularly for those service providers operating their own network infrastructure.

As at October 2013, the split between residential and business SIOs in CBD ESAs (based on the split of Telstra's retail basic access customers [REDACTED]), provides a significantly higher proportion of higher margin business SIOs for competitors to target.

[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED].

²⁰ Throughout this submission, the term "DSLAM-based" refers to infrastructure and services that utilise Telstra's ULLS or LSS access products to install exchange-based equipment (for example, DSLAMs) capable of offering voice or high speed broadband services (or both) to end users. For example, references to "DSLAM-based" competitors are references to competitors using either the ULLS or the LSS, in conjunction with DSLAMs, to provide services to end users.

²¹ DSLAM based competitors may be from the same corporate group. The number of active DSLAM based competitors in across Band 1 ESAs decreased from [REDACTED] to [REDACTED] in the last 12 months. Telstra understands that this has been as a result of industry consolidation as well as access seekers migrating customers from LSS to ULLS (see 4.3 above).

²² Telstra Internal Analysis

To June 2014, NBN had passed only 381,146 brownfields premises of which 281,294 were deemed serviceable.²³ An examination of the NBN Co roll out plan shows that there has been no/minimal infrastructure deployment in CBD areas to date. The roll out summary suggests only minimal NBN investment planned in the CBD in next three years.²⁴ This would suggest that the impact of the NBN in CBD areas on access seeker's investment schedules will generally be minimal. Meanwhile TPG, as noted in section 3.1 above, is pressing ahead with its VDSL FTTB rollout.

Former iiNet CEO noted the following in 2013, "*In terms of investment decisions, I don't think NBN is impacting that terribly either way*". "*We didn't light up any new DSLAMs in the last six months, and I don't foresee us doing any in the foreseeable future. Really, our focus is just increasing the ports in the exchanges we're in already.*"²⁵ This is consistent with the fact that DSLAMs in CBD ESAs have [REDACTED] spare capacity.

²³ NBN Co Weekly Progress Report, available at <http://www.nbnco.com.au/corporate-information/about-nbn-co/corporate-plan/weekly-progress-report.html>

²⁴ NBN Co, <http://www.nbnco.com.au/content/dam/nbnco/documents/q-s/rollout-summary-3-year-construction-plan-apr-2013.pdf>

²⁵ <http://www.zdnet.com/au/nbn-delays-work-in-our-favour-iinet-7000011603/>

4. Prior ACCC arguments on competition in CBD areas

As noted in section 1.2 above, the ACCC is required to turn its mind afresh to the question of whether it should provide CBD SAO Exemptions and whether such exemptions should be subject to appropriate conditions and limitations. In doing so, the ACCC may seek to consider its recent decisions on the declaration of fixed line services, including WLR and LCS. The following sets out a review of the factual basis of the ACCC's arguments for its decision to include CBD areas within the declarations of WLR and LCS.

In the ACCC's draft decision on the declaration of fixed line services²⁶ (Draft FLS Decision) the ACCC calculated the expected costs and revenues for access seekers and Telstra to supply services to **four types of end-users typically found in the CBD areas**. It substantially affirmed its Draft FLS Decision in its final decision on the declaration of fixed line services²⁷ (Final FLS Decision). The following reviews the factual basis of the ACCC's opinions for each of those four types of end-users and makes relevant observations on the ACCC's reasoning. Telstra then does the same in respect of the ACCC's additional reasoning and arguments.

4.1. Voice only residential end-users

The first category of end user the ACCC considered in the Draft FLS Decision was the average residential voice-only end user.²⁸ The ACCC noted that for a single line rental service, Telstra's national retail price is \$22.95 per month. Telstra notes that this line rental price is for Telstra's low income product HomeLine Budget which Telstra supplies as part of its low income measures carrier licence condition. This product has characteristics of low line rental but higher call costs. Telstra's analysis shows that out of its base of HomeLine Budget customers, [REDACTED] HomeLine Budget SIOs are in CBD areas.

Overall, Telstra has [REDACTED] "voice only" retail residential SIOs in CBD areas.

As there are [REDACTED] premises in CBD areas with only a single PSTN line supplied to it²⁹, or [REDACTED] of total "voice only" SIOs (residential or business, retail and WLR), the number of true "voice only" residential households in CBD areas is likely to very small.

The ACCC's intent is clearly stated to provide examples of the types of end-users "typically found in CBD areas and under the heading "average residential voice-only end-user". On the evidence, this is not a HomeLine Budget customer. A closer approximation for the average residential voice-only end user would be Telstra's most popular plan, namely HomeLine Plus. Also, with respect to a margin analysis, the more appropriate metric to use is average revenue per user or ARPU which includes calling revenue. This is because for HomeLine Budget margins on calling revenue are larger than for line rental and PSTN is sold as a bundle to end users rather than separate components. The build/buy decisions of access seekers are likely to be based on the ARPU available from customers rather than only one component of the available revenue from the customer.

[REDACTED]

The ACCC also referenced Optus' offer of a \$22 retail line rental product. Telstra notes that this product also features higher call costs, for example, 30c for a local call, and is tied to a 24 month contract. The ARPU that Optus receives for this product is not available to Telstra. However,

²⁶ ACCC, Fixed Service Review Declaration Inquiry, Public Inquiry into the Fixed Line Services Declaration, Draft Report, December 2013.

²⁷ ACCC, Public Inquiry into the Fixed Line Services Declaration, Final Report, April 2013

²⁸ At pages 59 and 60

²⁹ See Telstra Corporation Limited, Fixed Line Services Review: Response to the Commission's Draft Report on the Declaration Inquiry, Confidential Version, 14 February 2014, pages 14 to 15.

Telstra recommends that the ACCC seek out this information to enable it to construct a more meaningful analysis.

In Telstra's view, the conclusions that the ACCC reached in the Draft FLS Decision (which it then referenced in the Final FLS Decision³⁰) with respect to the margins available to access seekers in the supply of WLR to residential customers in CBD areas cannot be supported by the available evidence.

4.2. Small business end-users

The second category of end users that the ACCC considered in the Draft FLS Decision at pages 60 to 62) were sole traders at a single location such as a dental surgery, watch repairer or café. Relying on the information supplied by access seekers, the ACCC noted that this type of business would tend to represent around one third of all business establishments in the CBD. However, in relation to the number of lines that such customers would represent, they make up a very small proportion. Retail premises of all sizes³¹, combined, account for approximately 4 per cent of all floor space in CBD areas³².

The ACCC noted that this kind of business typically requires two line rental services, one for an EFTPOS machine and another for either a voice-only service or a bundled voice and broadband service. Telstra notes that the use of fixed line services for EFTPOS machines is being subsumed by the use of mobile EFTPOS machines. Telstra does not have data on the number of lines used for EFTPOS but considers that the number of transactions is a useful proxy. Telstra's data of the number of transactions made by EFTPOS over its networks shows that in June 2009, [REDACTED] was delivered over mobile in comparison to PSTN/ISDN, while in June 2014, mobile transactions accounted for [REDACTED]. Increasingly, the supply of EFTPOS transactions is bypassing traditional telecommunications providers' EFTPOS platforms and the role of telecommunications providers will be simply to provide the underlying infrastructure. Moreover, IP EFTPOS terminals are widely available for use where a fixed solution is preferred and the customer is connected to a ULLS or fibre based telecommunications network³³.

Therefore, where a business typically requires voice, broadband and EFTPOS, this could all be supplied via a single IP access without multiple lines. Alternatively, the merchant may prefer a mobile EFTPOS device, separate from the voice/broadband bundle.

The ACCC estimated the typical "usage charges" for a small business end-user based on information provided by access seekers but then sought to draw its conclusions solely on the basis of line rental charges without taking into account calling revenue. In Telstra's view, the supply of WLR by Telstra to access seekers must be considered as an input to a bundle of voice telephony services supplied to end users. End users will have very little utility for an access line without calling functionality. Telstra's retail yield for business lines supplying the small business segment is [REDACTED]. Using this number, the margin that access seekers could make on each service is [REDACTED]³⁴, an amount more than sufficient for access seekers to compete for customers.

For bundled customers, the ACCC's analysis produces access seeker margins between 22 to 29%. However, this analysis uses port costs as an input thus using WDSL as the underlying infrastructure supplying the broadband service³⁵. However, as set out in section 3.2 above, the

³⁰ At page 36.

³¹ Including not just sole traders but the many retail premises used by small to medium businesses and large corporate and government customers.

³² Using Melbourne as a proxy: retail space as a percentage of built space in Melbourne is 4%; see CLUE 2012 Small Area Report: Melbourne CBD, City of Melbourne – Melbourne City Research, page 5.

³³ For example, Suncorp's EFTPOS offerings where all terminals support IP networks:
<http://www.suncorpbank.com.au/financial-services/merchant-services/compare>

³⁵ See the FLS Draft Decision, page 61, footnote 149.

overwhelming majority of broadband supplied by access seekers using Telstra's infrastructure is through ULLS and LSS (████) rather than through WDSL. Hence the ACCC's analysis underestimates the margins available to access seekers.

4.3. Medium-sized business end-users

The third category of end users the ACCC considered in its Draft FLS Decision was medium sized businesses (at pages 62 to 64). Here the ACCC provides an example of a national retail chain with multiple locations both within and outside CBD areas: 25 within CBD areas and 25 outside CBD areas. As noted above, retail space within CBD areas is likely to be in the order of 4 per cent. Moreover, retail floorspace in Australia's CBD's accounts for less than 9 per cent of total retail stock³⁶. Therefore, the example of half of a retail business' retail outlets within CBD areas and half outside does not seem realistic.

In any event, for those locations within CBD areas, the ACCC assumes the exact same construct for each location as for the small business end user - namely a requirement for two access lines, one for an EFTPOS machine and another for a bundled voice and broadband service.

As noted in section 4.2, Telstra considers that the assumptions in relation to EFTPOS services are likely to be unrealistic.

Moreover, in Telstra's view, this characterisation of the voice and broadband needs of medium sized business end users in CBD areas is overwhelmingly narrow. There are thousands of medium sized business end users in CBD areas with a vast array of telecommunications needs, with many having complex requirements which are better serviced by technologies beyond PSTN type services. These types of end users are served by a variety of technology configurations which are suited to the competitive fibre networks or ULLS based offerings. For the ACCC to have assumed that their needs are a replica of those of a sole trader is not credible.

Even assuming that a business does exist with the characteristics described by the ACCC then such a business (with 25 – 50 locations mixed between CBD areas and other areas) is unlikely to still be buying individual phone services for each location. In Telstra's experience, service providers will market an IP-VPN solution with 25 – 50 accesses that will carry all their traffic, including: IP telephony, internet, video conferencing and so on. Medium sized businesses will be moving to direct engagement with staff through video conferencing and/or informational video training. Point of sale pricing, stock control and accounting is generally provided through centralized software solutions delivered to each retail outlet remotely. These solutions do not require WLR.

In the Draft FLS Decision, the ACCC produced a similar margin analysis for the medium business segment to that for the small business segment³⁷. Telstra does not consider that the technology solution is appropriate for this segment and Telstra repeats its concerns with the ACCC's methodology as set out in section 4.2 above.

4.4. Large business end-users

The fourth category of end users the ACCC considered in its Draft FLS Decision was large business end users (at page 64). Surprisingly, the ACCC again replicates the retail provider example but with more locations (200 retail locations within CBD areas with some corporate office requirements). Therefore, all the examples that the ACCC has provided are of businesses with retail outlets in the CBD. No other type of business is considered by the ACCC. For example, the headquarters of a banks, multinational corporations, accounting firms, architectural design firms, law courts, Government departments, insurance company, museums, universities and other types of organisations with a CBD presence were not considered. As noted above, retail space within CBD areas is likely to be in the order of 4 per cent. Moreover, retail floor

³⁶ Jones Lang Lasalle, Pulse, Research Report, May 2014, CBD Retail: The transformation and outlook, page 1.

³⁷ See the FLS Draft Decision, page 63.

space in Australia's CBD's accounts for less than 9 per cent of total retail stock³⁸. Therefore, the example of 200 retail outlets all located within CBD areas does not appear typical.

As set out in relation to medium sized businesses above, the larger the organisation, generally the more complex the telecommunications needs. However, even where those needs are not complex, the size of the customer means that it is more attractive for an access seeker to supply that customer using either fibre based or ULLS infrastructure (even if the price of WLR is set at \$22.84). It will be more attractive for service providers to self supply to gain even greater margins than those available from WLR. If this were not the case, then there is obviously regulatory error in setting the regulated prices for WLR and ULLS.

In the end, three of the ACCC's "four types of end users typically found in CBD areas" are all the same, namely a small retail outlet requiring one to two services. Accordingly, little or no consideration was given by the ACCC to other typical categories of end users in CBD areas. Without undertaking a more rigorous and complete analysis of other typical end user scenarios in CBDs there is significant risk of the ACCC underestimating the strong business case for infrastructure-based competitors in supplying the full spectrum of end users in CBDs and the benefits across all consumers that have been delivered against the backdrop of the longstanding exemptions in these areas.

4.5. Copper based voice only services in CBD areas

In both the Draft FLS Decision and Final FLS Decision the ACCC noted the number of voice only services in CBD areas³⁹ (refer to Appendix 2). As there are [REDACTED] premises in CBD areas with only a single PSTN line supplied to it⁴⁰, or [REDACTED] of total "voice only" SIOs (residential or business, retail and WLR) it is difficult to determine that "voice only" is a true characterisation of the needs of the CBD end user. Further, the term "voice only" is a misnomer as the use of the underlying service is not known.

Assuming that a proportion of these services are used for voice telephony, the Draft FLS Decision and Final FLS Decision noted the additional costs in moving from a traditional copper-based voice service to a VOIP service and indicated this as a reason for requiring access seekers to have continued access to WLR⁴¹. The cost of this technology is falling. For example, MyNetPhone provides a residential VoIP services for \$9.95 per month with 200 included local calls for customers with a broadband service⁴². MyNetPhone provides a converter for plugging a standard analogue handset into a broadband router for \$9.95. They provide other phone adaptors which enable an analogue fax machine to utilise an IP service from \$49.95⁴³. Another provider, Faktortel provides a VoIP service for \$8.95 per month for six months which includes a converter to enable an analogue phone to utilise VoIP⁴⁴.

For an access seeker, the greater margins available over ULLS or fibre based services should incentivise competitors to bundle the small additional cost of IP telephony into a 12 -24 month contract. However, the ACCC then noted that a contract limits the retail substitutability of these alternative services. End users are more than familiar with such contacts for bundles of broadband and voice and in relation to their mobile phone purchases. The ACCC has not found these bundles to be an inhibitor to competition in these other markets.

The ACCC noted its advice that end users are reluctant to upgrade to IP-based alternatives if these services are less reliable and cost more⁴⁵. However, the offers available show that this is

³⁸ Jones Lang Lasalle, Pulse, Research Report, May 2014, CBD Retail: The transformation and outlook, page 1.

³⁹ See page 64 of the Draft FLS Decision and page 42 of the Final FLS Decision.

⁴⁰ See Telstra Corporation Limited, Fixed Line Services Review: Response to the Commission's Draft Report on the Declaration Inquiry, Confidential Version, 14 February 2014, pages 14 to 15.

⁴¹ See pages 64 and 65 of the Draft FLS Decision and page 44 of the Final FLS Decision.

⁴² (<https://www.mynetfone.com.au/Residential/Home-Phone/Plans/MegaSaver>)

⁴³ <https://www.mynetfone.com.au/Residential/Home-Phone/VoIP-Online-Shop/Phone-Adaptors>

⁴⁴ http://www.faktortel.com.au/home_plans/8_95.php

⁴⁵ See page 65 of the Draft FLS Decision.

not the case. Ovum see that VoIP is now entrenched within the telecoms ecosystem and its use will grow increasingly over the next five years as it becomes the underlying technology for delivering voice over telecoms infrastructure⁴⁶. They opine that VoIP is now commonplace in the corporate voice market and is attracting a growing band of customers in the consumer market as VoIP smartphone and desktop apps proliferate⁴⁷.

Note that with the advent of the NBN, a large proportion of the Australian fixed voice telephony market will progressively shift to IP telephony. The whole of the Australian telecommunications user base will experience a change in technology and for many this will spur a technology upgrade to IP. This is especially relevant to businesses that make up a large proportion of copper lines in CBD areas. Where one or more of their business locations is to migrate to the NBN, whether or not within a CBD area, this may well trigger a company wide refresh to IP to ensure a consistent whole of business experience. Even if this does not occur, the business will become familiar with the IP environment from their sites in an NBN area and therefore, the future "sell" for other areas will be easier.

As noted, the term "voice only" as used above is a misnomer. It is not clear what these services are used for. As noted by the ACCC some of these may be used for EFTPOS, facsimile, security alarms, elevator telephones and back-up telephones. Again, the migration to the NBN is necessitating the transition of these technologies to an IP environment. Significant work is being carried out by both retail service providers and providers of the underlying services, including through Communications Alliance, to ensure they can move away from reliance on the PSTN and compatibility with the NBN⁴⁸. Therefore, now more than ever before, these services will become contestable to service providers offering technology other than PSTN.

In Telstra's view, the process of competition should be spurring access seekers to develop better ways to attract customers to newer technologies, including through innovative pricing solutions for handset upgrades. Customers are increasingly adopting IP based solutions for their telephony needs. The failure of access seekers in certain situations to sell the benefits of IP telephony should not be a catalyst for re-regulation.

4.6. Competitive substitutes for supplying voice-only services in CBD areas

In the Draft FLS Decision, the ACCC considered that, from an access seeker's perspective, voice only services supplied using access seeker DSLAM infrastructure and fibre infrastructure are not fully substitutable for voice services supplied using WLR⁴⁹. It noted evidence of higher costs in providing voice services using access seekers equipment and the ULLS.

In its Final FLS Decision, the ACCC acknowledged Telstra's submission that ULLS-based access seekers may be able to effectively supply multiple voice services to a single premise, however, it reverted back to evidence supplied by access seekers that the economies of scale of using ULLS to supply voice services are such that it is only viable to do so if certain minimum purchase requirements are met⁵⁰. The ACCC has not disclosed publicly the threshold. However, Telstra again notes that there are [REDACTED] premises in CBD areas with only a single PSTN line supplied to it⁵¹, or [REDACTED] of total "voice only" SIOs (residential or business). This is a very small number of services, particularly when distributed over 5 different CBD cities and 16 exchange areas for which the ACCC is seeking to apply the SAOs. Therefore although a particular line may be voice only, there are likely to be other lines into the same premises which are either voice and broadband services, or a combination of both and when combined can economically be supplied by access seekers.

⁴⁶ Ovum Consumer OTT VoIP Outlook: 2013-18, 21 November 2013, page 3.

⁴⁷ Ibid.

⁴⁸ <http://www.commsalliance.com.au/Activities/committees-and-groups/host-wg>

⁴⁹ See pages 65 and 66 of the Draft FLS Decision.

⁵⁰ See page 43 of the Final FLS Decision.

⁵¹ See Telstra Corporation Limited, Fixed Line Services Review: Response to the Commission's Draft Report on the Declaration Inquiry, Confidential Version, 14 February 2014, pages 14 to 15.

4.7. Retail prices in CBD areas

In the Draft FLS Decision, the ACCC considered that without a price regulated WLR product, retail prices were likely to be kept high not just for the voice only SIOs supplied by access seekers but also for the voice-only SIOs supplied by Telstra retail⁵².

The ACCC itself acknowledges that where there are multiple voice only lines to a premises, then ULLS based competition would be effective⁵³. Therefore, the concern of the ACCC must be for the remainder of voice only services, those supplied without multiples to the same premises. Telstra again notes that there are [REDACTED] premises in CBD areas with only a single PSTN line supplied to it⁵⁴, or [REDACTED] of total "voice only" SIOs (residential or business).

In any event, these services, which are part of the national market for the supply of voice-only services, are supplied by Telstra and its competitors on a national basis.

There is little differentiation between Telstra and its competitors in their standing offers for the supply of voice only services within CBD areas from national pricing, even though in some areas access seekers have had access to a regulated WLR price while in others they have not.

At page 44 of the Final FLS Decision, the ACCC accepts that most telecommunications service providers set nationally uniform retail prices but does not accept that this makes it unlikely that, given the low proportion of WLR services in CBD areas, any reduction in the WLR price in CBD areas will lead to a reduction in prices for end-users. The ACCC noted that business end users are often offered discounts on the package of services they purchase.

In respect of LCS, in the Draft LCS Decision, the ACCC did not find an issue with the price of LCS or other competitive concern⁵⁵. Yet, it considered it warranted re-regulation it as it is purchased with WLR. It noted that "*Telstra would have an incentive and ability to raise the LCS price in CBD areas*". Telstra has not increased the LCS price since December 2005, meaning it has decreased in real terms over the past 9 years. Therefore, there is scant merit in the ACCC's argument for the regulation of LCS in CBD areas. To so easily impose regulation without meritorious justification following a long period of regulatory forbearance appears to be inconsistent with the statutory criteria and market evidence including past conduct in CBD areas.

4.8. Corporate and Government end-users whole of business solution

In the Draft FLS Decision the ACCC sets out its views on the "whole of business" requirements of corporate and government end-users⁵⁶. It again references large retail chains that require a small amount of voice-only lines for their smaller retail outlets. As set out in part 5.4 above, this kind of corporate and government end user must surely represent a very small proportion of CBD area customers. The ACCC did not outline the proportion of corporate and government customers that operate this type of business or have these particular telecommunications requirements (which in Telstra's view are quite specific to a only a very small sub-set of corporate and government customers).

In addition, the ACCC did not outline in its reasoning in either the Draft FLS Decision or the Final FLS Decision the proportion of lines of a **typical** corporate and government bid that were voice only CBD lines as opposed to the overall size of the bid. In Telstra's view, the proportion would be small. Telstra estimates at Table 11 below that the overall number of corporate and government "voice only" copper based SIOs within CBD areas is [REDACTED] [REDACTED] servicing the broad array of business types and telecommunications needs in CBD areas of corporate and government customers. Telstra estimates that there are [REDACTED] fixed voice telephony ends in the total corporate and

⁵² See page 66 of the Draft FLS Decision.

⁵³ See page 43 of the Final FLS Decision.

⁵⁴ See Telstra Corporation Limited, Fixed Line Services Review: Response to the Commission's Draft Report on the Declaration Inquiry, Confidential Version, 14 February 2014, pages 14 to 15.

⁵⁵ See page 67 of the Draft FLS Decision.

⁵⁶ See pages 67 and 68 of the Draft FLS Decision.

government market segment. Therefore, CBD copper “voice only” SIOs make up [REDACTED] of the total. In its reasoning the ACCC is again looking at diminishing numbers of services to which it has ascribed some impact on overall competition in the large and highly competitive market for corporate and government customers. The ACCC did not cite any evidence to show that there has been any overall impact to competition in bids for corporate and government customers due to the wholesale prices charged by Telstra for WLR in CBD areas.

In its Draft FLS Decision, the ACCC sought to argue that without the removal of the CBD exemptions, it would reduce access seekers' ability to compete effectively with Telstra for retail customers including for corporate and government end users seeking a “whole of business” solution. The ACCC argued this may hinder the efficient use of access seeker's existing DSLAM and switching infrastructure, including access seeker infrastructure located outside of CBD areas – existing DSLAMs in CBD and non-CBD areas may not be efficiently utilised to provide the broadband services required by those end-users.⁵⁷ In Telstra's view the proposition has not been made out that the price of WLR in CBD areas has had an effect on the competitiveness of the broader corporate and government market. If anything, the existing and significant quantity of investment in alternative infrastructure both within CBD areas and outside of CBD areas is sufficient to enable access seekers to compete with Telstra using higher margin ULLS and fibre based offerings and incentivises access seekers to compete aggressively to ensure that those assets are efficiently utilised.

In its Draft FLS Decision the ACCC then added that it agreed with access seeker submissions that there is little risk that the removal of exemptions would create a risk of inefficient investment in the CBD areas. It considered that existing infrastructure owners will be keen to exploit their networks in areas where they have already entered to avoid using WLR and LCS when it is efficient to do so⁵⁸. In Telstra's view, access seekers will apply rational business decisions in response to regulatory decisions. Where an ACCC decision enables access seekers to take advantage of an access price that produces a lower cost input than using their own infrastructure, then many access seekers will prefer that lower cost input over using their own infrastructure - despite the greater (and long term) benefits to end users that are delivered by infrastructure based competition over undifferentiated resale.

4.9. Encouraging the economically efficient use of, and investment in, infrastructure

In its Final FLS Decision, the ACCC, referencing the Draft FLS Decision, noted the slowing investment in exchange equipment since 2009 and the reduced incentives to invest in infrastructure due to the NBN rollout.⁵⁹ The ACCC opined that maintaining CBD exemptions could lead to inefficient investment in copper-based equipment due to the higher price of WLR (relative to regulated rates), particularly as access seekers are seeking to expand and extend their customer bases during the transition to the NBN to achieve economies of scale in supplying NBN-based retail services⁶⁰.

As set out in section 3.2 above, the amount of spare capacity on installed copper-based competitive infrastructure shows that installing additional DSLAMs would not be rational for access seekers. Economically efficient use of that already installed infrastructure would argue for the utilisation of that access capacity through ULLS/LSS based service offerings rather than under-utilisation encouraged by low prices for WLR set by regulation.

⁵⁷ See page 70 of the Draft FLS Decision.

⁵⁸ See page 70 of the Draft FLS Decision.

⁵⁹ See page 38 of the Final FLS Decision.

⁶⁰ Ibid.

5. Applying the SAOs in respect of WLR and LCS in CBD areas

As set out in section 1.2 above, in making a FAD, the ACCC is required to take into account, amongst other things, whether the determination will promote the LTIE. The following considers this and other statutory criteria as they apply to the factual background of WLR and LCS in CBD areas.

5.1. The Bottleneck Test

The object of Part XIC of the Act is to promote the LTIE of carriage services or services provided by means of carriage services. Telstra believes that the proper scope of Part XIC should therefore be targeted carefully to focus on the regulation of the supply of carriage services to address bottleneck issues with respect to particular infrastructure. In its “Fixed Services Review—Discussion Paper on the Declaration Inquiry” (July 2013), the ACCC found that in determining whether declaration would promote the LTIE, it uses well-established economic principles to analyse the expected impacts of regulating a service, including whether the relevant infrastructure exhibits enduring bottleneck characteristics that affect competition, any-to-any connectivity or efficiency and investment. It stated that “declaration is likely to promote the LTIE where infrastructure facilities are enduring bottlenecks”.⁶¹

A facility or service is only a bottleneck if it is a necessary natural monopoly input into the production process of a firm to compete in a downstream market. Strictly, a bottleneck service exists only if it passes two economic tests:⁶²

1. it is used to manufacture a specific good or service and there must be no alternative input or process which enables a competitor to produce an equivalent final good or service at a comparable cost (**alternative inputs test**); and
2. there must be no alternative, substitutable *final* good or service that can be manufactured and sold at a comparable price without using that input (**downstream substitutes test**).

If both tests are met, then an economic problem that may justify access regulation exists. If one or both of the tests are not met, then there is no structural impediment to competition and no economic basis justifying the imposition of regulation. This is because, if one or both of the tests are not met, “*the owner of the essential facility (bottleneck) is constrained from exercising monopoly power due to direct competition from substitutes or indirect competition because substitutes exist to products that use its input.*”⁶³

In the context of WLR and LCS services supplied in CBD areas, neither of the two tests is met. The LCS and WLR cannot reasonably be considered an essential facility or an enduring bottleneck in CBD areas. With regard to wholesale inputs, access seekers have a choice of multiple alternative wholesale inputs within CBD areas including ULLS (and resale services supplied through ULLS) and services supplied through alternative fibre networks (either self-supplied, or via wholesale services supplied through those networks). With regard to the second test, there are a wide range of alternative end user services that are available and competing in the market alongside WLR-based services.

Telstra still considers that this is the appropriate test for ex-ante regulation. However, it is not the test the ACCC applied either in its recent decision on the declaration of WLR and LCS or its recent decision in respect to its review of the declaration of the DTCS⁶⁴ (DTCS Decision) of March 2014. These tests seek to apply ex-ante regulation to something less than an enduring bottleneck. Therefore, Telstra will consider the application of the SAOs to WLR and LCS in the context of the more conservative test as applied by the ACCC in its DTCS Decision.

⁶¹ Discussion Paper, page 11.

⁶² See King. S., (1997), “National competition policy”, Economic Record, 73, 270-284, p.273.

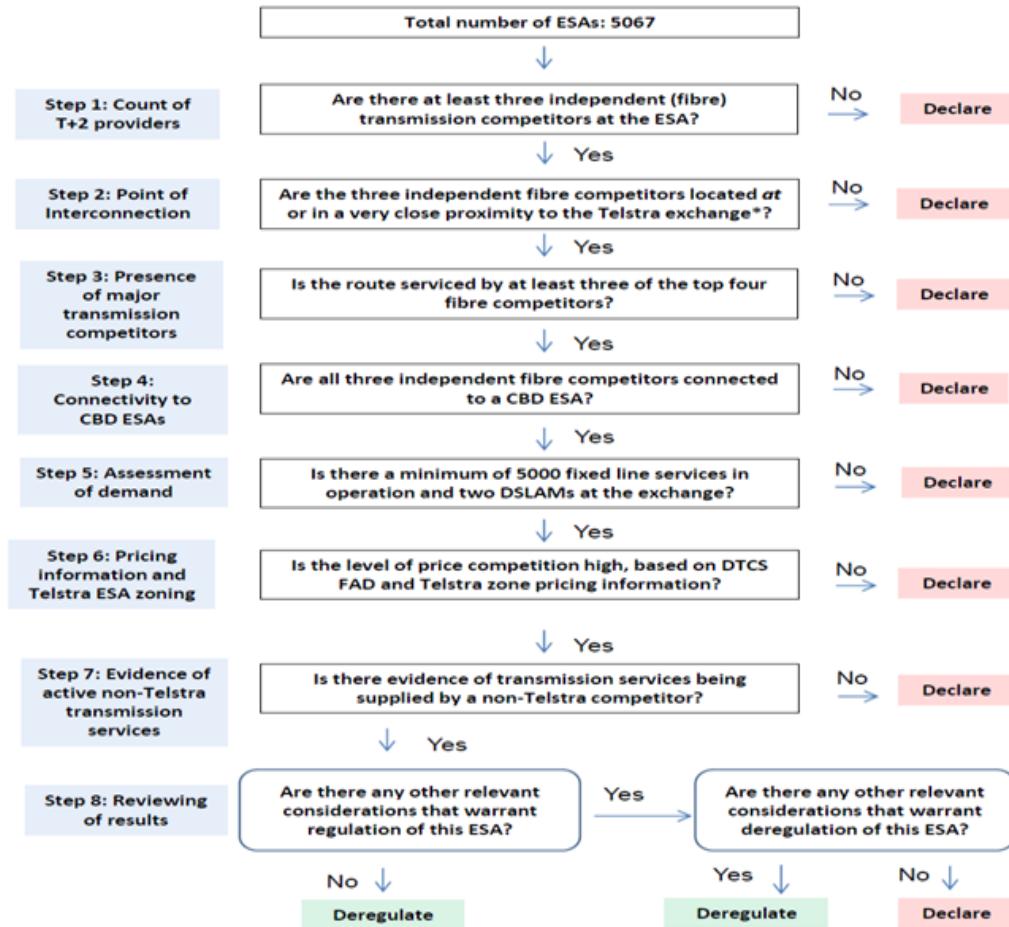
⁶³ See King. S., (2013), “Report on essential facilities, access regulation and value-added wholesale services on the NBN”, p.7.

⁶⁴ ACCC, Domestic Transmission Capacity Service, An ACCC Final Report on the review of the declaration for the Domestic Transmission Capacity Service, Public Version, March 2014 .

5.2. The DTCS test

In its recent DTCS Decision, the ACCC applied a more conservative test with eight steps to determine which services should be subject to regulation and which should be exempt as its revised competition assessment methodology.⁶⁵ An outline of the approach is set out in Figure 3 below.

Figure 3: DTCS test



The ACCC's rationale for this approach was that:

"the declared DTCS is largely characterised by significant barriers to entry, limited supply or demand side substitutability and a dominant incumbent. The ACCC considers it is essential that access seekers are able to gain access to the DTCS at a reasonable price to ensure continued innovation and vigorous competition in downstream markets. This access must be balanced against providing the correct incentives for efficient investment in the market to ensure the long-term interests of end-users are also addressed."⁶⁶

This balancing of the right to access against investment incentives is further explained by the ACCC:

"The ACCC considers that where there is the presence of competition, or the appropriate conditions for competition, removing regulation will not be detrimental to the objective of promoting competition. The removal of regulation will likely promote facilities based

⁶⁵ See DTCS Decision, page 14.

⁶⁶ See DTCS Decision, page 55.

competition as it would send correct signals to the market that regulation will be removed where facilities based competition is occurring or likely to occur.”⁶⁷

5.3. Application of a graduated test to WLR and LCS in CBD areas

The following seeks to apply a graduated test to the current competitive dynamic in CBD areas in considering the application of the SAOs to WLR and LCS. The test does not apply perfectly, and therefore the application has been developed for the purposes of WLR and LCS.⁶⁸

Step 1: Is there a sufficient number of alternative infrastructure suppliers?

As set out in section 3 above, there is significant fibre infrastructure in CBD areas which can and does provide a complete substitute for Telstra's copper based infrastructure. Each CBD ESA has multiple (between five and ten) competitive fibre providers (see Table 11 below) – this is far less than the amount required for consideration of an exemption from the DTCS declaration of at least three independent transmission (fibre) competitors at each ESA.

ULLS is also available in all CBD area exchanges. There is [REDACTED] DLSAM based competitors in each of the CBD ESAs (refer to Table 1 below). [REDACTED]

[REDACTED] The number of DSLAM providers in each of the CBD ESAs is reflective of the favourable conditions for ULLS entry in those ESAs such as their larger size in terms of active PSTN SIOs per exchange and a higher proportion of higher margin business customers.

Table 1: Number of fibre providers and DSLAM providers in each CBD ESA

ESA	State	Number fibre providers ⁶⁹	Number DSLAM providers ⁷⁰
BATMAN	VIC	8	[REDACTED]
BULWER	WA	7	[REDACTED]
CHARLOTTE	QLD	7	[REDACTED]
CITY SOUTH	NSW	10	[REDACTED]
DALLEY	NSW	11	[REDACTED]
EDISON	QLD	6	[REDACTED]
EXHIBITION	VIC	7	[REDACTED]
FLINDERS	SA	8	[REDACTED]
HAYMARKET	NSW	11	[REDACTED]
KENT	NSW	11	[REDACTED]
LONSDALE	VIC	7	[REDACTED]
PIER	WA	8	[REDACTED]
PITT	NSW	11	[REDACTED]
SPRING HILL	QLD	6	[REDACTED]
WAYMOUTH	SA	8	[REDACTED]
WELLINGTON	WA	8	[REDACTED]

⁶⁷ See DTCS Decision, page 82.

⁶⁸ Steps 2 and 4 do not provide comparable considerations in the context of WLR and LCS.

⁶⁹ ACCC, 2013 – ESAs with 2 or more fibre asset owners, September 2013.

⁷⁰ Telstra Internal analysis of ULLS and LSS access seeker infrastructure to end June 2014 (may be from the same corporate group).

Again, the number of competitive ULLS providers is far less than the amount required for consideration of an exemption from the DTCS declaration – of at least three independent transmission (fibre) competitors at each ESA (see Step 1 of the DTCS methodology).

Step 3: Presence of major competitors⁷¹

The ACCC has information on the identity of the fibre and ULLS providers at each CBD ESA. Upon examination of that data, Telstra is confident that it will show a strong overlap between the competitive fibre providers and ULLS providers and that the overlap is of Telstra's main competitors in fixed line service competition (see Step 3 of the DTCS methodology).

Step 5: Assessment of demand

Each CBD ESA has over 5,000 active PSTN SIOs with an average of [REDACTED]

[REDACTED], thereby satisfying the comparable Step 5 of the test.

Step 6: Pricing competition

There has been no evidence to suggest that the level of price competition for end users in CBD ESAs is any less than for end users in areas where WLR has been regulated (e.g. Band 2) (see Step 6 of the DTCS methodology). It is more efficient for larger competitors to price nationally than to have introduced differentiated pricing for a small addressable target market such as the remaining end users on PSTN in CBD areas.

By the ACCC's own admission, where there are multiple voice only lines to a premise, then ULLS based competition would be effective. With [REDACTED] premises supplied with a single SIO across the five CBD areas, this is a very small fragment of what is itself a small market segment.

The reasoning of the ACCC in the Final FLS Decision seems to indicate that the ACCC accepts access seeker submissions that a minimum purchase threshold is required for viable ULLS supply. This number has not been publicly disclosed through the ACCC's prior decisions and Telstra queries whether access seekers are efficient in their supply of services to end users.

Nevertheless, due to the small number of premises with only a single service "voice only" service supplied to it (that is, there is only a small cohort of end users with a demand for only a single service), in Telstra's view, the potential for access seekers to provide multiple services to end users who require them exists. There is no structural impediment to this occurring.

Step 7: Evidence of non-Telstra services

Telstra has supplied LCS and WLR in CBD areas throughout the period during which those services were exempt from regulation in CBD areas: LCS since 2002 and WLR since 2006. Therefore, these have always been available to access seekers to supply those particular end users where they have been unable or unwilling to use ULLS. Telstra notes that as expressed by the ACCC in the DTCS Decision the removal of regulation is to encourage additional investment in alternative infrastructure. This is evidenced in the CBD areas through the increasing use of ULLS at the expense of Telstra's retail basic access service and WLR (see Step 7 of the DTCS methodology).⁷²

WLR (and LCS) are now declared services and hence must be made available on request. This enables the continuation of the situation where access seekers are able to use WLR as a "stop gap" measure while access seekers continue to invest in their own infrastructure, introduce

⁷¹ Steps 2 and 4 do not provide comparable considerations in the context of WLR and LCS.

⁷² As WLR is a lower level service than the ULLS, Telstra's provision of WLR is taken to be equivalent to transmission supplied by a non-Telstra competitor. However, this has now been superseded by the declaration of WLR.

further efficiencies in the use of that infrastructure and refine their “sales pitch” for the use of IP technology as it becomes more prevalent and cost effective for end users.

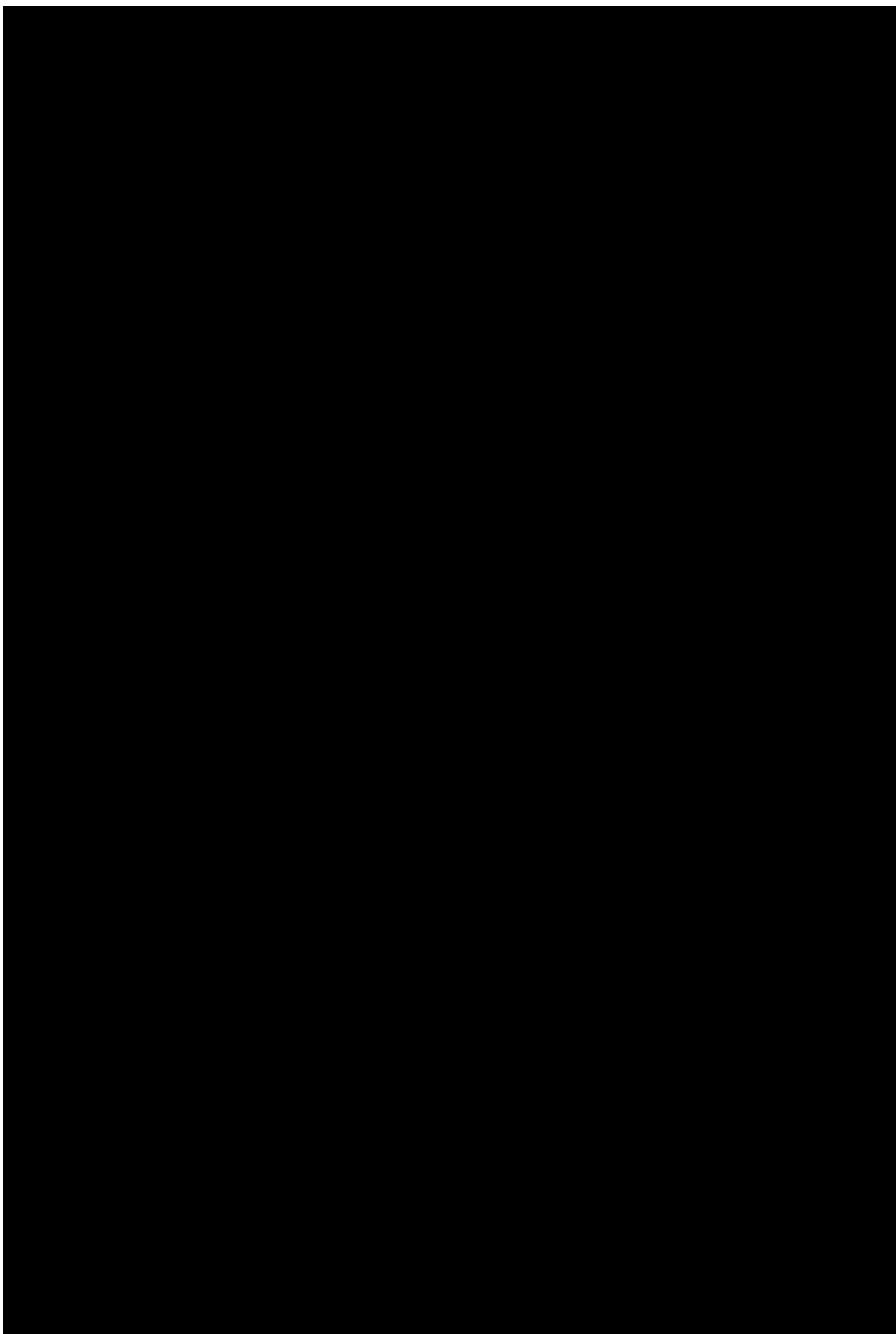
Final Step: Any other factors?

The ACCC’s DTCS methodology provides for a “catch all” at the end of its process through step 8 *“are there any other relevant considerations that warrant regulation”*.

The ACCC, throughout its Draft FLS Decision and Final FLS Decision, referenced the higher price charged by Telstra in CBD areas than the regulated rate for WLR in other areas. Telstra notes that as the price for WLR has not changed since December 2005, it has been decreasing in real terms over the period. If Telstra had made increases to the price in line with inflation the rate would be \$34.88 for residential end users and \$40.15 for business end users.

The prices Telstra was charging enabled access seekers to compete for end users using WLR, as evidenced by the comparable market share between Telstra retail and access seekers in CBD areas and other areas set out in Figure 4 below. Access seekers have been more successful in competing against Telstra retail in CBD areas than in areas where WLR has been price regulated, with a clear preference over time to using ULLS in both CBD and non-CBD areas.

Figure 4: Market share using copper – Telstra Retail, WLR and ULLS 2009, 2013, 2014



However, Telstra does concede that the quantum of margin available to access seekers using WLR in Band 1 would be lower than an access seeker using WLR in Band 2. However, it is not within the remit of the ACCC's considerations to seek to maintain or improve the margins of access seekers. As noted above, the existence of regulated WLR is as a transition to access seekers investing in their own infrastructure and exploring efficiencies. This incentive was created through the pricing differential.

Moreover, as discussed in section 2 above, the notion that Telstra should have been pricing WLR at the level of the regulated price in other areas and that as that did not occur this evidenced a lack of competition is flawed. The difference between the WLR price in CBD areas and other areas where regulation applied was principally due to a change in the ACCC's methodology for determining the regulated price in those other areas (from a retail-minus methodology, to a building block method). The fact that Telstra did not change its pricing in CBD areas when the ACCC changed its pricing approach is not evidence of a lack of competition in those areas.

The expert report of Mr Alex Sundakov considers whether using a utility pricing model provides a useful approximation of pricing outcomes from a workably competitive market and how pricing evidence should be evaluated relative to evidence on market structure. The Sundakov Report is attached as Appendix 3. In summary, the report finds that⁷³:

- In networks that have high sunk costs, utility pricing models provide weak indications of pricing outcomes from a workably competitive market. Regulated prices derived from such cost-of-service models cannot be legitimately used as a proxy for competitive market prices;
- Both pricing and market structure evidence can be used to assess the presence of market power. In circumstances where the effects of market structure are unclear—e.g. it is difficult to infer the extent of competition when there are few current market participants—literature suggests that competitive price benchmarks may be a better guide. However, when there is no reliable measure of competitive price, and the market structure consists of numerous participants, including evidence of recent entry, market structure is a better indication of the presence of market power;
- For a pricing benchmark to be a reliable indicator of market power, it needs to be derived from observed evidence in competitive settings or, at the very least, from pricing models that capture competitive market conduct. Since provision of WLR and LCS services by Telstra is a substitute for the provision of voice-based services by DSLAM-based competitors, pricing behaviour and service offerings of such competitors provide a more useful pricing benchmark than the cost of service model;
- No DSLAM-based competitors—despite a large number of such competitors in the CBD areas and despite the relatively low level of investment required to voice-enable DSLAMs—offer voice only wholesale services. Since the ULLS price has been continuously regulated in all service areas even while WLR and LCS were exempted in some ESAs, the lack of competitive offerings is a strong indication that the price charged by Telstra for such wholesale services in exempted areas was below the level that would induce competitive entry;
- The ACCC observes that the WLR and LCS prices in exempted areas were above the price derived from the Telstra cost of service model. However Mr Sundakov observes that in the exempted areas, with [REDACTED] DSLAM-based competitors on average, above-market pricing of wholesale services by Telstra should have induced profitable entry by those competitors. The most obvious conclusion from this apparent contradiction is that the pricing model does not reflect the outcomes of a workably competitive market, particularly the margin between ULLS and WLR/LCS that would prevail in such a market;
- The gap between market pricing and prices that result from utility cost-of-service models is not surprising. This is particularly the case where a cost-of-service model has to estimate prices for multiple services utilising common assets. In such situations, accounting cost allocation rules are inevitably approximations of the underlying economic concepts. In a workably competitive market, a firm supplying multiple layers of access through services that may compete with each other would be unlikely to set prices so as just to recover the average cost per service;
- Overall, Mr Sundakov observes that the disparity between the observed pricing for WLR/LCS in the formerly exempted areas and the results of the model indicates more about the limitations of the model than about the market.

Therefore, the price differential between the cost based regulated rates and the rates Telstra was charging for WLR and LCS in CBD areas do not signal competitive issues but may indeed be closer to what one would expect in a fully competitive market. Telstra notes that a hypothetical

⁷³ See pages 1 to 2 of the Sundakov Report.

competitive WLR price, on the basis of analysis previously provided to the ACCC, would be in the order of [REDACTED]⁷⁴.

Overall, on the basis of the ACCC's DTCS methodology, there is little to warrant regulation, however, on the flip side there is much to warrant the absence of regulation. Particularly, the ACCC's own expressed objective to provide the correct incentives for efficient investment. There is much that access seekers can yet do to drive efficiencies and persuade customers to migrate to new IP based technologies that will soon become ubiquitous across the Australian telecommunications industry with the rollout of the NBN. The higher proportion of business customers in CBD areas means that continued acceptance of efficiency enhancing technologies will easily translate to even greater migration away from traditional PSTN services. It would be curious for the ACCC to be seen to be standing in the way of an enabler of greater efficiencies across the economy as a whole through business adoption of newer technologies by creating incentives through increased regulatory intervention towards mature legacy technologies.

⁷⁴ See page 12 of the Castalia Report referencing an expert report by Alexander Sundakov, 14 October 2011 on the "Inquiry into Varying the Exemption Provisions in the Final Access Determinations for the WLR, LCS and PSTN OA Services".

6. Conclusion

As shown in section 5 above, whether applying the bottleneck test or the more conservative DTCS methodology to CBD areas, the outcome is the same, namely that there is little to justify regulation of WLR and LCS in CBD areas. This was the view of the ACCC from its first consideration of the issue in 2002, through its decisions in 2006 and 2009. Throughout that period to the present, due to the substantial presence of competitive infrastructure and ULLS based competition in CBD areas (and the regulatory forbearance that was in place for over a decade), the structural market results were as expected - greater levels of competition and investment in competitive infrastructure and a decline in Telstra's share.

The facts of the operation of the market are clear and well established. Irrespective of the threshold test or prism through which the statutory criteria is applied, on a fair and reasonable consideration of market conditions in CBD areas - whether through a bottleneck test or some other formulation⁷⁵ - it would be reasonable for a regulator to conclude that the market is workably competitive and that regulatory forbearance is required:

- to further encourage investment in alternative infrastructure; and
- because to do otherwise would be an unreasonable and unnecessary interference that would not seek to promote competition in the market but would in fact likely distort it.

In reaching its changed position on the declaration of WLR and LCS in CBD areas in the Draft FLS Decision and Final FLS Decision, the primary factor (and only substantive change to market facts in CBD areas since previous reviews) that the ACCC appeared to give significant weight to was that Telstra was not charging prices for WLR that were in line with or below regulated (cost based) prices the ACCC had set for areas outside CBDs in 2011. It should be noted that the price points for WLR and LCS in CBD areas were previously based on regulated rates, from the time that WLR and LCS in non-CBD areas was priced using a retail minus methodology. Telstra kept those rates in market in CBD areas and did not increase them, meaning that they have been falling in real terms since 2005. This has provided access seekers with price stability and certainty over an extended period.

The ACCC subsequently changed its methodology and the price of regulated WLR and LCS in non-CBD areas, by moving from away from a retail minus methodology and instead applying a cost based methodology. The ACCC is again reviewing pricing of WLR in non-CBD areas and the prices of WLR in those areas may change again.

Any gap between in-market pricing in CBD areas and regulated rates in other areas cannot be taken as evidence of market power, in and of itself. In the present case, the gap has arisen largely due to a change in the ACCC's pricing methodology.

As noted by Mr Sundakov:

"utility pricing models are designed to estimate the cost of service of a monopoly provider in a setting where risk allocation differs drastically from the risk allocation that would be expected in a workably competitive market. As a result, prices derived from such models cannot be reliably used as competitive market benchmarks".⁷⁶

Earlier decisions by the ACCC to grant regulatory forbearance in CBD areas have led to greater levels of infrastructure competition within CBD areas; therefore it is difficult to point to negative outcomes from them. It appears counter-intuitive that as the market becomes more competitive

⁷⁵ For example, the ACCC's own recent formulation used for DTCS exemptions on competitive routes/ESAs; or the Australian Competition Tribunal's threshold approach used in granting WLR, LCS and PSTN OA exemptions in 2009.

⁷⁶ See page 12 of the Castalia Report.

and PSTN services are moving beyond maturity and increasingly being substituted for IP based telephony and mobile services, the ACCC has decided to re-regulate such services in CBD areas. Some may seek to argue that the market would have been even more competitive with a lower WLR price. In Telstra's view, it may well have generated greater numbers of services using WLR – at the expense of investment in alternative infrastructure and/or ULLS based services. However, this would mean that in the long run competition would not be served as competitors would not have had the same incentives to invest in their own infrastructure (including via regulated ULLS) resulting in lower levels of competition, innovation, and differentiation.

This investment in alternative infrastructure has provided end users in CBD areas with the benefits of extensive competition which manifests in multiple choices of competitive service providers, network technologies, and product and service differentiators to meet their needs.

In determining the application of the SAOs in the current price and non-price FAD consultations for WLR and LCS, the ACCC has the opportunity to consider carefully the evidence of strong infrastructure and ULLS based competition in CBD areas. Given the difficulties identified with the analysis undertaken by the ACCC to date in respect of the CBD exemptions, any reasonable approach to applying the LTIE in the context of the current FAD process requires the ACCC to re-examine the issue. The ACCC should undertake a complete and conventional market analysis to determine under section 152BC(h) whether the standard access obligations should apply to Telstra in these areas, taking into account the updated market evidence set out in this submission.

Unlike a declaration process, if the ACCC does not believe an unconditional exemption is appropriate for whatever reason, it should also consider possible conditions and limitations under section 152(3)(h), as suggested by the Federal Court in respect of the now repealed section 152AR(3).⁷⁷ When operating in conjunction with an exemption decision conditions and limitations would promote the long term interests of end users compared to a decision to continue to regulate:

"The question that the Tribunal should have asked itself is whether it was satisfied that an order should be made exempting Telstra from its obligations under s 152AR(3) of the TPA subject to whatever conditions or limitations were appropriate that would promote the LTIE."

This submission has highlighted that customers are highly contestable in CBD areas through adoption of new technologies providing business and residential customers with cheaper and better solutions to efficiently and effectively manage their businesses and daily lives. The historical reliance on the PSTN through resale is no longer credible in these areas as set out in this submission, particularly as large swathes of the country migrate onto the NBN. Telstra's competitors have made significant market share gains on Telstra in CBD areas and end users have benefitted in those areas from real choice, differentiated services and competitive prices. Telstra sees no reason why this would not continue in the absence of regulation. It is in the LTIE for the ACCC to send a strong signal to all service providers or potential providers in CBD areas that they need to continue their focus on investment, innovation and differentiation rather than being distracted by any regulatory incentives to move onto or back to simple, undifferentiated legacy resale services.

⁷⁷ Full Federal Court (Jacobson, Lander and Foster JJ) in *Telstra v Australian Competition Tribunal* [2009] FCAFC 23

Appendix 1: Applicable case law

The Full Federal Court (Jacobson, Lander and Foster JJ) in *Telstra v Australian Competition Tribunal* [2009] FCAFC 23 made a number of observations on certain aspects of the statutory criteria set out above:

- **Competition and promoting competition**

At paragraphs 224 and 225, their Honours agreed with Telstra's submissions that “*competition is a process or state of affairs and is not concerned with the position or protection of individual competitors*” and “*“promoting competition” involves the idea of creating appropriate conditions or an environment for improving competition from what it would otherwise be and not as requiring satisfaction that an actual increase in the level of competition has already taken place or will definitely take place in the future*”.

- **With and without test**

At paragraphs 159 and 160 their Honours agreed with Telstra's submission “*that an essential part of the analytical enquiry required by s 152AT(4) is a comparison between the “future with” the exemptions and the “future without” the exemptions and an assessment, in the light of that comparison, of which state of affairs is in the LTIE*”. The test contained in the now repealed section 152AT(4) required that the ACCC not make an order for an exemption from the SAOs unless it was satisfied that the making of the exemption order will promote the LTIE, whereas under section 152BCA requires the ACCC to *take into account* whether the access determination will promote the LTIE.

However, at paragraphs 243 and 244 their Honours noted: “*in our view, what is required by ss 152AB and 142AT is not some balancing between the short term and long-term but rather due regard to the LTIE. In any given case, this may well involve consideration of the existing state of the market and the future impact of the particular thing under consideration, both in the immediate future and over the longer term. The reference to the short-term, in such a context, would not necessarily be an error or involve a misconstruction of the requirements of s 152AB*”, indicating that the “with and without test” is relevant to considering whether something will promote the LTIE as specified in section 152AB rather than confined to the now repealed section 142AT.

- **Conditions or limitations**

Repealed section 152AT(5) requires that an order by the ACCC in respect of an exemption application “*may be unconditional or subject to such conditions or limitations as are specified in the order*”. Similarly, section 152(3)(h) provides that an access determination may provide that the SAOs are not applicable to a carrier either unconditionally or subject to such conditions or limitations as are specified in the determination. In Telstra's view, their Honours' decision on the application of section 152AT(5) at paragraphs 288 to 292 as set out below is directly applicable to the construction of paragraph 152BC(3)(h):

“288. We think the contention advanced by Telstra that the Tribunal did not apply its mind to the conditions or limitations before concluding that the decision made by the ACCC making the orders under s 152AT ought to be set aside must be accepted. We think that the Tribunal proceeded on the basis contended for by Telstra, in that it assumed that a consideration of conditions or limitations did not arise until after it had determined that it was satisfied that the making of the orders exempting Telstra would promote the LTIE.”

“289. For the reasons we have already given in relation to the construction of s 152AT(5), we think, with respect, the Tribunal erred. We reject the suggestion implied in the Tribunal's reasons that it is appropriate to proceed on a two stage basis: first, by determining whether it is satisfied that an order exempting would promote the LTIE; and

secondly, if so satisfied, whether it is of the opinion that it ought to impose conditions or limitations.

290. We think the question of conditions or limitations must be approached at the same time as the ACCC (or the Tribunal on review) is considering whether it is satisfied that an order exempting will promote the LTIE. If it were otherwise and the two stage process were appropriate, then, of course, it would rarely be the case that any conditions or limitations would be imposed because the decision maker would have already reached the conclusion that the order which has been sought should be made because it would promote the LTIE. That would leave s 152AT(5) with little work to do.

291. It is our opinion that s 152AT(5) is always engaged in a consideration of any application under s 152AT or the consideration of any order which might be made under s 152AT(5). An instance of how s 152AT(5) can be used is, in our opinion, the way in which the ACCC used it on Telstra's applications to it. It has used the subsection for the purpose of imposing a regime which, at the very least, reduced the barriers to entry.

292. We think therefore, with respect, that the Tribunal asked itself the wrong question. The question that the Tribunal should have asked itself is whether it was satisfied that an order should be made exempting Telstra from its obligations under s 152AR(3) of the TPA subject to whatever conditions or limitations were appropriate that would promote the LTIE."

Further guidance on the assessing what will occur in the future, for the purposes of the with or without test (as part of the LTIE) is found in *Application by Chime Communications Pty Ltd (No2)* [2009] ACompT 2 at [13] per Finkelstein J, R Davey and Professor D. Round: "Moreover, while past events are not a certain guide to the future, their evaluation is a necessary, if not integral step in determining what is likely to happen in the future: see *Minister for Immigration and Ethnic Affairs v Guo* (1997) CLR 559 at 574-575; *Minister for Immigration and Multicultural Affairs v Epeabaka* (1999) 84 FCR 411 at 419. This is particular so in the "future without" analysis as the status quo is often a useful guide as to what is likely to happen in the future."

Appendix 2: Competition and share of supply on the Telstra fixed line network

The tables below show the actual state of competition in the copper based segment of the market in CBD areas. This market segment is also subject to competition from the large quantity of alternate infrastructure described above and more generally with mobile substitution playing a part. Therefore, the movement of SIOs between the different classes of copper based infrastructure described below is only a small part of the overall competitive picture.

The tables contain data for each of the CBD areas through the years June 2012 to June 2014. This period is a year prior to the ACCC's commencement of its consideration of the declaration of fixed line services, to one year after that time. Through this short period, a number of trends clearly emerge:

- The overall trend for basic line rental (retail basic access and WLR) is a decline of [REDACTED]. This compares to a decline of [REDACTED] in Band 2 and [REDACTED] nationally.
- WLR declined by [REDACTED] over the period, while the decline in retail basic access was [REDACTED].
- The increase in ULLS, by which access seekers are able to supply voice or a bundle of voice and broadband, was a significant [REDACTED].
- Access seekers were also more successful in their increase in wholesale DSL of [REDACTED], as opposed to an increase in retail DSL of [REDACTED].
- Although LSS declined by [REDACTED], in terms of SIOs, this was a loss of [REDACTED] SIOs, compared to the total gain by access seekers of [REDACTED] for ULLS and [REDACTED] for WDSL.

Therefore, on all counts, in the recent past period during which WLR has not been regulated, access seekers have been significantly more successful than Telstra Retail in the copper based segment of the broader competitive environment in CBD areas.

Voice services are also supplied using copper based ISDN, which is also supplied by access seekers on a wholesale basis to other providers. As at June 2014, there were [REDACTED] basic rate services (with two voice equivalents for each service) in CBD ESAs across retail and wholesale.

Table 2: Total WLR SIOs in each of the CBD areas and total

CBD	2012	2013	2014
Melbourne	[REDACTED]	[REDACTED]	[REDACTED]
Perth	[REDACTED]	[REDACTED]	[REDACTED]
Brisbane	[REDACTED]	[REDACTED]	[REDACTED]
Sydney	[REDACTED]	[REDACTED]	[REDACTED]
Adelaide	[REDACTED]	[REDACTED]	[REDACTED]
Total	[REDACTED]	[REDACTED]	[REDACTED]

Table 3: Total Retail Basic Access in each of the CBD area and total

CBD	2012	2013	2014
Melbourne	[REDACTED]	[REDACTED]	[REDACTED]
Perth	[REDACTED]	[REDACTED]	[REDACTED]
Brisbane	[REDACTED]	[REDACTED]	[REDACTED]
Sydney	[REDACTED]	[REDACTED]	[REDACTED]

CBD	2012	2013	2014
Adelaide			
Total			

Table 4: Total ULLS SIOs in each of the CBD areas and total

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 5: Total Wholesale ADSL SIOs in each of the CBD areas and total

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 6: Total Retail ADSL SIOs in each of the CBD areas and total

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 7: Total LSS SIOs in each of the CBD areas and total

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 8: Total voice only WLR in CBD areas

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 9: Total voice only retail basic access SIOs in CBD areas

CBD	2012	2013	2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 10: Total voice only residential SIOs in CBD areas for WLR/BA

CBD	Retail BA Bus / Res split	BA2014	WLR 2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Table 11: Total voice only “enterprise and government” SIOs in CBD areas for WLR/BA

CBD	Retail Basic Access E&G split	Voice only E&G Retail BA 2014	Voice only “E&G” WLR 2014
Melbourne			
Perth			
Brisbane			
Sydney			
Adelaide			
Total			

Appendix 3: Sundakov Report

Attached separately.