Local Services Review

***Draft Decision* on whether or not the ACCC should extend, vary or revoke its existing declaration of the local carriage service**

March 2006

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Abbreviations

AAPT	AAPT Limited
ACCC	Australian Competition and Consumer Commission
ACN	Australian Communications Network Pty Ltd
Act	*Trade Practices Act 1974*
CAN	Customer access network
CCC	Competitive Carriers Coalition
Discussion paper	ACCC, *Local Services Review 2005*, April 2005.
xDSL	Digital subscriber line
ESA	Exchange Service Area
IDD	International Direct Dial
LAS	Local access switch
LCS	Local Carriage Service
LTIE	Long Term Interests of End–users
Macquarie	Macquarie Telecom Pty Ltd
Optus	SingTel Optus Pty Ltd
PIE II	PSTN Ingress and Egress model, version 2
POI	Point of interconnection
PowerTel	PowerTel Limited
Primus	Primus Telecommunications Pty Ltd
PSTN	Public Switched Telephone Network
PSTN O/T	PSTN Originating and Terminating Access Services

RMRC	Retail-minus retail costs
SAOs	Standard Access Obligations
SPC	Southern Phone Company
STD	Subscriber Trunk Dialling
STS	Standard telephone service
Telstra	Telstra Corporation Limited
TS	Transit switch
TELRIC	Total element long-run incremental cost
TSLRIC	Total service long-run incremental cost
TSLRIC+	Total service long-run incremental cost plus indirect costs
ULLS	Unconditioned Local Loop Service
USF	Universal Service Fund
USO	Universal service obligation
VoIP	Voice over IP

Glossary

Access Provider	Carrier or carriage service provider who supplies declared services to itself or other persons — see s. 152AR of the Act.
Access Seeker	Service provider who makes, or proposes to make, a request for access to a declared service under s. 152AR of the Act.
Customer access network	The network which enables the connection of telephones and other customer premises equipment to switching technology. It consists of a network of conduits and pipes in the ground with a mixture of cables containing copper wires and optical fibres. It has two parts – the distribution network and the feeder network.
Distribution network	That part of the customer access network connecting the distribution point (typically a pillar) to the network termination point.
Exchange	A generic term for a major node in an exchange service area (e.g. an IRIM, RSS/RSU, LAS, TS).
Exchange Service Area	A part of the feeder network connected to a given exchange.
Feeder network	That part of the customer access network connecting the exchange to the distribution point (typically a pillar).
Local access switch	This equipment provides ring current, dial tone and battery feed to end-users, as well as switching calls locally to other local access switches. It also provides number analysis for call routing and call charge recording, and enhanced (or supplementary) services such as call waiting and call diversion.

Pre-selection	Function that enables an end-user or service provider to select a preferred carrier or carriage service provider for a certain type of call (e.g. long distance calls).
Service provider	Defined in s. 86 of the *Telecommunications Act 1997*. Means a carriage service provider or a content service provider.
Total service long run incremental cost	See Australian Competition and Consumer Commission, *Access Pricing Principles – Telecommunications: A guide*, July 1997.

1 Summary

On 22 April 2005, the Australian Competition and Consumer Commission (ACCC) commenced a public inquiry to review the local carriage service (LCS) declaration. In doing so, the ACCC sought to explore a range of issues relating to the declaration of the LCS, including whether or not to continue to declare this service, and whether or not to declare a line rental service.

The ACCC's inquiry examined in detail the appropriate definitions of markets related to the supply of the LCS and line rental. The ACCC found that, outside of the CBD areas of the major cities, there is in the foreseeable period a relative paucity of options at the wholesale level for both of these services, with implications for competition at both the wholesale and retail level. However, with regards to CBD areas, it was found that facilities-based competition is relatively more robust, and thus the ACCC has formalised its previous CBD exemption through an adjustment to the service descriptions for both the LCS and line rental service.

While there is evidence of the development of a number of potential supply substitutes for line rental and the local call service, currently these services are not sufficiently interchangeable to consider them as effective substitutes. However, given the speed of technological change and uncertainties regarding take-up of alternatives to Telstra's wholesale services, it is difficult to be too definitive about substitution trends beyond a two year period.

Given this, the ACCC considers that it is appropriate to limit the periods of declaration to two years commencing 1 July 2006. A shortened declaration period will allow the ACCC to revisit its analysis of the relevant markets for these services to reassess the extent to which alternative or substitute services to line rental are evident and therefore the appropriateness of continued declaration. It is expected that over this time a significant level of the current uncertainty around network and service alternatives is likely to have been resolved.

An alternative approach would be for the ACCC to make an ex ante determination on what particular areas, possibly on an Exchange Service Area (ESA) or some other geographic basis, are likely to be subject to effective competition from alternative network platforms or other regulated services and carve out these areas from the service description. Such an approach has been used previously in relation the wholesale transmission service where specific geographic routes have been excluded from regulation on the basis of the presence of alternative transmission facilities. This is relatively straightforward in the case of the transmission service which has always been characterised on a route by route basis.

The ACCC considers that, with the exception of CBD areas, it is inappropriate and in practice more problematic to attempt to excise particular areas on some generalised or ad hoc basis from the national market explicitly in the service description. Unlike transmission services, the nature of any carve out would be far less discrete and clear cut, given the patchwork of differing network footprints that exist or are in prospect. That said, the ACCC would be prepared to further consider what form of ex ante approach might be possible if more comprehensive work is undertaken.[1]

At this stage, the ACCC considers that a formalised ex post framework for forbearance from existing declarations (through the granting of exemptions from the Standard Access Obligations (SAOs)) will provide a superior mechanism for targeted withdrawals from regulation in sub-regions of the national market found to be effectively competitive outside the CBD areas. That is, the ACCC believes that competition will develop at different rates across regions of the national market. Thus, while it is not appropriate at this stage to exempt large or discrete portions of the market through the service description, where an applicant could demonstrate that an exemption could be justified on the basis of effective competition in any given sub-region, an exemption would provide a superior tool for targeted withdrawal. Therefore, while the ACCC plans to revisit its examination of the broader national market in 2008 with a view to determining the future of the declaration of these services, forbearance from regulation in specific sub-regions will still be available to applicants at any time through the periods of declaration. This provides an appropriate tool for withdrawing from regulation in a timely and targeted fashion.

Continued declaration of the LCS under current market conditions is likely to encourage efficient investment in infrastructure used to supply local telephony (and possibly other) services. It will continue to facilitate market entry and enable service providers to obtain information about demand characteristics and the likely responses of competitors, thus reducing the risks associated with infrastructure deployment, thereby promote ULLS and other facilities-based provision. This will enable service providers to make efficient decisions about when to deploy customer access infrastructure. Similarly, Telstra’s incentives to efficiently invest in replacement technologies to deliver voice services will not be unduly affected by the regulation of these services as long as the pricing approach does not lead to either under-recovery (reducing their capacity to invest in new networks) or over-recovery (reducing their incentive to invest in more efficient technologies) of costs for these services.

To the extent that this encourages entry of efficient providers of retail services and improves the ability of service providers to use re-supply as a stepping stone to the roll-out of their own infrastructure, then continued declaration will also encourage economic (dynamic) efficiency. In this regard, declaration would facilitate market entry and enable service providers to obtain information about demand characteristics

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1 It is noted for example that Telstra have submitted in their submission to the fixed services review for a national audit of infrastructure to determine where bottlenecks may persist and to customise regulation accordingly.

and the likely responses of competitors, thus reducing the risks associated with infrastructure deployment. This should enable service providers to make efficient decisions about when to deploy customer access infrastructure.

An essential issue addressed by submitters during the inquiry was whether or not a line rental service should be declared. There was good reason in 1999 to see local calls and line rental as part of the one service given that they were usually consumed as a bundle at both the wholesale and retail level. However, the ACCC considers that market changes since that time mean that such bundling from a regulatory perspective is now less appropriate.

The ACCC notes that the decision to declare a wholesale line rental service as a service in its own right is in effect a formalisation of an existing implicit right to access this service through the currently applied LCS pricing. The ACCC considers that there are strong reasons justifying its independent declaration, and has chosen to do so in order to make its continued regulation as explicit and transparent as possible.

Line rental is an essential input for the provision of voice and data services. As such, tying the line rental service to particular downstream services inhibits an access seeker's ability to compete with Telstra on a resale basis as the reseller is unable to differentiate the price or quality of the service. As such, resellers are effectively forced to pass on the regulated bundled price.

The ACCC therefore considers that declaring a line rental service would promote competition in downstream retail markets by providing greater certainty to access seekers on the provision and pricing of this service. It will also enable the line rental service to be used to provide other services rather than just as part of a bundled voice-access service.

The ability of service providers to compete effectively in the local telephony market through re-supplying local telephony services is largely influenced by the terms and conditions on which local call services are supplied to them. In this context, continued declaration of the LCS is likely to constrain the ability of suppliers to unduly influence competition in the local telephony services market. This should continue to promote competition in that market and in the long distance telephony services market where local telephony services are bundled with long distance calls for customers who prefer to acquire those services from a single provider and thereby promote the interests of end-users.

The extent to which continued declaration will promote competition is likely to depend on the prices paid by access seekers for the declared services. The ACCC has given consideration to the pricing approach it would be likely to adopt in the event that it was called upon to assess an access undertaking, or arbitrate an access dispute in relation to the declared services. The ACCC's draft view is that as an interim approach it will continue to employ the retail-minus approach currently used to price these services.

However, the ACCC intends to pursue the development of an alternative, robust and independent cost model capable of producing reasonable cost estimates. When such a model becomes available, the ACCC is likely to re-evaluate pricing principles for the declared services with a view to implementing cost-based prices where this is found to be in the LTIE.

The ACCC seeks comment from interested parties on this draft decision and the matters set out and relied upon in reaching the draft decision. To this end, the ACCC seeks submissions on this draft decision by **21 April 2006**.

Please forward written submissions to:

Andrew Deitz
Australian Competition and Consumer Commission
GPO Box 520J
MELBOURNE VIC 3000

Ph: 03 9290 1955
Fax: 03 9663 3699
e-mail: andrew.deitz@accc.gov.au

Any queries on this draft decision should be directed to Andrew Deitz on 03 9290 1955 in the first instance.

Once all submissions to this draft decision have been received, the ACCC will, after consideration of these submissions, proceed to issue a final decision. At this stage, the ACCC expects to issue a final decision by **June 2006**.

2 Introduction

On 22 April 2005, the Australian Competition and Consumer Commission (ACCC) commenced a public inquiry to review the local carriage service (LCS) declaration. The review, which was required under the *Trade Practices Act 1974* (TPA), was to determine under section 152ALA, having regard to the long-term interests of end users (LTIE), whether to:

- extend or further extend the expiry date of the declaration
- revoke the declaration
- vary the declaration
- allow the declaration to expire without making a new declaration under section 152AL or
- allow the declaration to expire and then to make a new declaration under section 152AL

In response to the discussion paper, the ACCC received six submissions. A list of written submissions received is at **Appendix A.**

2.1 The local carriage service

The LCS is used by service providers to supply local calls to end-users. It allows competitive entrants to resell local calls without deploying substantial alternative infrastructure.

As set out in the current service description reproduced in Appendix B, the LCS is the supply of an end-to-end voice grade carriage service between two points within a standard zone.[2] The access provider is responsible for the carriage of the call between the calling party and called party; access seekers re-sell this service to end-users. Vertical elements which can be self-supplied, or competitively sourced, by the service provider are not included. In re-supplying the local carriage service to the end-user the service provider may seek to 'value add' or simply resell.

2 The term 'standard zone' is defined in s. 227 of the Telecommunications Act.

2.2 Structure of this report

This report sets out the information, analysis and reasons upon which the ACCC's decision has been made. The report is structured as follows:

- **Section 3** briefly outlines the access regime and relevant provisions governing the declaration process.
- **Section 4** outlines the principles for developing service descriptions that is the focus of this inquiry, namely the local carriage service.
- **Section 5** outlines the role and purpose of regulatory intervention and the relationship between resale and facilities-based competition.
- **Section 6** identifies the markets that are the focus of the inquiry and assesses the need to declare a line rental service.
- **Section 7** outlines the test for declaration of the local carriage service.
- **Section 8** outlines the test for declaration of the line rental service.
- **Section 9** outlines the pricing principles for the declared services.

Appendix A provides a list of submissions received.

Appendix B provides the current service description of the local carriage service.

Appendix C provides the proposed service description of the local carriage service.

Appendix D provides the proposed service description of the line rental service.

3 Legislative background

3.1 The access regime

Part XIC of the TPA sets out a telecommunications access regime. The ACCC may determine that particular carriage services and related services are declared services. Once a service is declared, carriage service providers (CSPs) are required to comply with standard access obligations (SAOs) in relation to supply of the declared service. The SAOs facilitate the provision of access to declared services by service providers in order that service providers can provide carriage services and/or content services. In addition to its SAOs, a carrier, CSP or related body must not prevent or hinder access to a declared service.

3.2 Maintaining, varying or revoking an existing declaration

Section 152ALA of the *Trade Practices Act 1974* ('the TPA') requires the ACCC to review each declaration within the year preceding its expiry date.

The purpose of the review, as set out in section 152ALA(7) of the TPA, is to determine whether or not the expiry date for the declaration should be extended, whether the declaration should be allowed to expire, whether or not the declaration should be varied or revoked or if a new declaration should be made. An extension to an expiry date, or the expiry date for a new declaration, may not be for a period exceeding five years.

Pursuant to section 152ALA of the TPA, the ACCC must:

- hold a public inquiry in accordance with Part 25 of the Telecommunications Act 1997 on whether to extend the expiry date for the declaration, vary or revoke the declaration, or allow the declaration to expire (with or without a new declaration being made)
- prepare and publish a report setting out the ACCC's findings.

The ACCC's powers to extend the expiry date for a declaration, vary or revoke a declaration, or allow a declaration to expire (with or without a new declaration being made), are set out in sections 152AL, 152ALA and 152AO of the TPA. In exercising these powers, the ACCC is required to consider the effect on the LTIE of carriage services and services provided by means of carriage services.

3.3 The ACCC's approach to the LTIE test

The ACCC must decide whether declaring the service would promote the LTIE of carriage services, or of services supplied using carriage services ('listed services').

Section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives.

- promoting competition in markets for listed services
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users
- encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied.

Section 152AB also provides further guidance in interpreting these objectives.

The three objectives are discussed below.

3.3.1 Promoting competition

Subsections 152AB(4) and (5) provide that, in interpreting this objective, regard must be had to, but is not limited to, the extent to which the arrangements will remove obstacles to end-users gaining access to listed services. The Explanatory Memorandum to Part XIC of the TPA states that:

> ...it is intended that particular regard be had to the extent to which the...[declaration]... would enable end-users to gain access to an increased range or choice of services. [3]

This criterion requires the ACCC to make an assessment of whether or not declaration would be likely to promote competition in the markets for listed services.

The concept of competition is of fundamental importance to the TPA and has been discussed many times in connection with the operation of Part IIIA, Part IV, Part XIB and Part XIC of the TPA.

> In general terms, competition is the process of rivalry between firms, where each market participant is constrained in its price and output decisions by the activity of other market participants. The Trade Practices Tribunal (now the Australian Competition Tribunal) stated that:

[3] Trade Practices Amendment (Telecommunications) Act 1997 (Cth) Explanatory Memorandum.

> In our view effective competition requires both that prices should be flexible, reflecting the forces of demand and supply, and that there should be independent rivalry in all dimensions of the price-product-service packages offered to consumers and customers.
>
> Competition is a process rather than a situation. Nevertheless, whether firms compete is very much a matter of the structure of the markets in which they operate.[4]

Competition can provide benefits to end-users including lower prices, better quality and a better range of services over time. Competition may be inhibited where the structure of the market gives rise to market power. Market power is the ability of a firm or firms profitably to constrain or manipulate the supply of products from the levels and quality that would be observed in a competitive market for a significant period of time.

The establishment of a right for third parties to negotiate access to certain services on reasonable terms and conditions can operate to constrain the use of market power that could be derived from the control of these services. Accordingly, an access regime such as Part IIIA or Part XIC addresses the *structure* of a market, to limit or reduce the sources of market power and consequent anti-competitive conduct, rather than directly regulating conduct which may flow from its use, which is the role of Part IV and Part XIB of the TPA. Nonetheless, in any given challenge to competition, both Parts XIB (or IV) and XIC may be necessary to address anti-competitive behaviour.

To assist in determining the impact of potential declaration on downstream markets, the ACCC will first need to identify the relevant market(s) and assess the likely effect of declaration on competition in each market.

Section 4E of the TPA provides that the term 'market' includes a market for the goods or services under consideration and any other goods or services that are substitutable for, or otherwise competitive with, those goods or services. The ACCC's approach to market definition is discussed in its *Merger Guidelines*, June 1999 and is also canvassed in its information paper, *Anti-competitive conduct in telecommunications markets*, August 1999.

The second step is to assess the likely effect of declaration on competition in each relevant market. As noted above, subsection 152AB(4) requires that regard must be had to the extent to which declaration will remove obstacles to end-users gaining access to listed services.

The ACCC considers that denial to service providers of access to necessary upstream services on reasonable terms is a significant obstacle to end users gaining access to services. In this regard, declaration can remove such obstacles by facilitating entry by service providers, thereby providing end users with additional services from which to

[4] Re Queensland Co-operative Milling Association Ltd; Re Defiance Holdings Ltd (1976) ATPR 40-012, 17,245.

choose. For example, access to a mobile termination service may enable more service providers to provide fixed to mobile calls to end-users. This gives end-users more choice of service providers.

Where existing market conditions already provide for the competitive supply of services, the access regime should not impose regulated access.[5] This recognises the costs of providing access, such as administration and compliance, as well as potential disincentives to investment. Regulation will only be desirable where it leads to benefits in terms of lower prices, better services or improved service quality for end-users that outweigh any costs of regulation.

In the context of considering whether declaration will promote competition, it is therefore appropriate to examine the impact of the proposed service description on each relevant market, and compare the state of competition in that market with and without declaration. In examining the market structure, the ACCC considers that competition is promoted when market structures are altered such that the exercise of market power becomes more difficult; for example, because barriers to entry have been lowered (permitting more efficient competitors to enter a market and thereby constrain the pricing behaviour of the incumbents) or because the ability of firms to raise rivals' costs is restricted.[6]

3.3.2 Any-to-any connectivity

Subsection 152AB(8) provides that the objective of any-to-any connectivity is achieved if, and only if, each end-user who is supplied with a carriage service that involves communication between end-users is able to communicate, by means of that service, or a similar service, with other end-users whether or not they are connected to the same network. The reference to 'similar' services in the TPA enables this objective to apply to services with analogous, but not identical, functional characteristics, such as fixed and mobile voice telephony services or Internet services which may have differing characteristics.

The any-to-any connectivity requirement is particularly relevant when considering services that involve communications between end-users.[7] When considering other types of services (such as carriage services that are inputs to an end-to-end service or distribution services such as the carriage of pay television), the ACCC considers that this criterion will be given less weight compared to the other two criteria.

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5 Trade Practices Amendment (Telecommunications) Act 1997 (Cth) Explanatory Memorandum.

6 See also *Re Sydney International Airport* [2000] ACompT 1 at paragraph 106 for discussion on when competition is promoted.

7 Trade Practices (Telecommunications) Amendment Act 1997 (Cth) Explanatory Memorandum.

3.3.3 Efficient use of, and investment in, infrastructure

Subsections 152AB(6) and (7) provide that, in interpreting this objective, regard must be had to, but not limited to, the following:

- whether it is technically feasible for the services to be supplied and charged for, having regard to:
- the technology that is in use or available
- whether the costs that would be involved in supplying, and charging for, the services are reasonable
- 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 interests of the supplier or suppliers of the service, including the ability of the supplier or suppliers to exploit economies of scale and scope
- the incentives for investment in:
  - — (i) the infrastructure by which the services are supplied; and (ii) any other infrastructure by which the services are, or are likely to become, capable of being supplied: in determining the extent to which a particular thing is likely to encourage the efficient investment in other infrastructure, the ACCC must have regard to the risks involved in making the investment.

These matters are interrelated. In many cases, the LTIE may be promoted through the achievement of two or all of these criteria simultaneously. In other cases, the achievement of one of these criteria may involve some trade-off in terms of another of the criteria, and the ACCC will need to weigh up the different effects to determine whether declaration promotes the LTIE. In this regard, the ACCC will interpret long-term to mean the period of time necessary for the substantive effects of declaration to unfold.

Economic efficiency has three components.

- *Productive efficiency* refers to the efficient use of resources within each firm such that all goods and services are produced using the least cost combination of inputs.
- *Allocative efficiency* refers to the efficient allocation of resources across the economy such that the goods and services that are produced in the economy are the ones most valued by consumers. It also refers to the distribution of

production costs amongst firms within an industry to minimise industry-wide costs.

- *Dynamic efficiency* refers to the efficient deployment of resources between present and future uses such that the welfare of society is maximised over time. Dynamic efficiency incorporates efficiencies flowing from innovation leading to the development of new services, or improvements in production techniques.

The ACCC will need to ensure that the access regime does not discourage investment in networks or network elements where such investment is efficient. The access regime also plays an important role in ensuring that existing infrastructure is used efficiently where it is inefficient to duplicate investment in existing networks or network elements.

3.3.4 The technical feasibility of supplying and charging for particular services

This incorporates a number of elements, including the technology that is in use or available, the costs of supplying, and charging for, the services and the effects on the operation of telecommunications networks.

In many cases, the technical feasibility of supplying and charging for particular services given the current state of technology may be clear, particularly where there is a history of providing access. The question will be more difficult where there is no prior access, or where conditions have changed. Experience in other jurisdictions, taking account of relevant differences in technology or network configuration, will be helpful. Generally the ACCC will look to an access provider to demonstrate that supply is not technically feasible.

3.3.5 The legitimate commercial interests of the supplier or suppliers, including the ability of the supplier to exploit economies of scale and scope

A supplier's legitimate commercial interests encompass its obligations to the owners of the firm, including the need to recover the cost of providing services and to earn a normal commercial return on the investment in infrastructure. The ACCC considers that allowing for a normal commercial return on investment will provide an appropriate incentive for the access provider to maintain, improve and invest in the efficient provision of the service.

A significant issue relates to whether or not capacity should be made available to an access seeker. Where there is spare capacity within the network, not assigned to current or planned services, allocative efficiency would be promoted by obliging the owner to release capacity for competitors.

Paragraph 152AB(6)(b) also requires the ACCC to have regard to whether the access arrangement may affect the owner's ability to realise economies of scale or scope. Economies of scale arise from a production process in which the average (or per unit) cost of production decreases as the firm's output increases. Economies of scope arise from a production process in which it is less costly in total for one firm to produce two (or more) products than it is for two (or more) firms to each separately produce each of the products.

Potential effects from access on economies of scope are likely to be greater than on economies of scale. A limit in the capacity available to the owner may constrain the number of services that the owner is able to provide using the infrastructure and thus prevent the realisation of economies of scope associated with the production of multiple services. In contrast, economies of scale may simply result from the use of the capacity of the network and be able to be realised regardless of whether that capacity is being used by the owner or by other carriers and service providers. Nonetheless, the ACCC will assess the effects of the supplier's ability to exploit both economies of scale and scope on a case-by-case basis.

3.3.6 The impact on incentives for investment in infrastructure

Firms should have the incentive to invest efficiently in infrastructure. Various aspects of efficiency have been discussed already. It is also important to note that while access regulation may have the potential to diminish incentives for some businesses to invest in infrastructure, it also ensures that investment is efficient and reduces the barriers to entry for other (competing) businesses or the barriers to expansion by competing businesses.

There is also a need to consider the effects of any expected disincentive to investment from anticipated increases in competition to determine the overall effect of declaration on the LTIE. The ACCC will be careful to ensure that services are not declared where there is a risk that incentives to invest may be dampened, such that there is little subsequent benefit to end-users from the access arrangements.

4 Service description

A fundamental step in determining whether a given service should be declared is to establish how the service in question should be described. This gives interested parties a basis point from which to discuss whether the service should be declared, and gives parties a firm idea of the service that access providers would be required to supply were the service to be declared. It also assists the ACCC by giving it a field within which it can meaningfully analyse whether declaration of the service, so defined, would promote the LTIE.

As the note to sub-section 152AL(3) states:

> Eligible services may be specified by name, by inclusion in a specified class or in any other way.[8]

The Explanatory Memorandum for the *Trade Practices Amendment (Telecommunications) Bill 1996* adds:

> In making a declaration of an eligible service, the ACCC will have a high level of flexibility to describe the service, whether it be in functional or any other terms. This will enable, where appropriate, the ACCC to target the access obligations (which are triggered by a declaration) to specific areas of bottleneck market power by describing the service in some detail, or to more broadly describe a service which is generally important (such as services necessary for any-to-any connectivity).[9]

4.1 Principles for developing a service description

When developing the description of an eligible service, the ACCC is guided by the object of Part XIC of the TPA, which is to promote the LTIE.

In most cases, some degree of technical specification is required. However, the ACCC's preference is to describe the service in terms which are as functional as possible. In such a situation, the declaration will leave the access provider with flexibility to determine the most efficient way of supplying the service. This also provides more flexibility to the access seeker in the type of service that can be provided within the ambit of the declared service and avoids distorting technological or innovative developments. Technical terms may, however, be appropriate where a functional description would provide scope for ambiguity which could be exploited by the access provider in a manner that hinders access.

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8 See Acts Interpretation Act 1901 (Cth) s. 46(2).

9 Trade Practices (Telecommunications) Amendment Bill (1996) Explanatory Memorandum, item 6, proposed s. 152AL.

The eligible service should be described in a manner which provides sufficient clarity for application of the SAOs.

The service should be one for which it is technically feasible to supply and charge. In addition, the service should be one that a potential access provider is supplying to itself or others.

5 Role and purpose of regulatory intervention

The Discussion Paper for the local services review indicates that the purpose of the review is twofold:

1. to determine whether the LCS declaration continues to be in the LTIE and, if so, what form ongoing regulation of the LCS should take

2. to consider a range of local call service issues and determine whether local services regulation can be more appropriately structured to encourage competition and promote efficiency in a range of telecommunication markets.

The ACCC's approach to determining whether declaration of the LCS is in the LTIE will be discussed in subsequent sections. In this section the second purpose for the review – more general issues about the regulation of LCS and the impact of local call service regulation on competition and efficiency in the telecommunications market – will be taken-up. A central issue in this broader discussion is the relationship between resale and facilities-based competition. Here it should be noted that a number of submissions to the Discussion Paper argued forcefully against what they see as the ACCC's bias against resale or service based competition.

Other submissions, Telstra's in particular, responded to the theme in the Discussion Paper about regulatory options, specifically the use of Part XIB as well as other powers in promoting efficient competitive outcomes. The relationship between resale and facilities–based competition and regulatory options will be discussed in detail in this section.

5.1 Relationship between resale and facilities-based competition

5.1.1 Issues raised by the discussion paper

At the time of the declaration of the LCS, the ACCC believed that the LCS would provide a stepping stone towards a more facilities-based model of competition. The ACCC has frequently made clear what it sees as the advantage of facilities/infrastructure based competition:

> The expansion of infrastructure has brought significant benefits to consumers. There has been a general downward trend in the prices of most call services with the price of an average basket of telecommunications services falling by 20.1 per cent in real terms between 1997–98 and 2002–03. And in the year since the ACCC intervened in the ADSL pricing case, broadband take-up has exceeded 1 million – a massive 120 per cent increase in just 12 months.
>
> Importantly, the explosion in broadband customers has been shared by both Telstra and its wholesale competitors.

> Broadband take up has now reached the point where it is becoming increasingly viable for access seekers to roll-out their own DSL infrastructure into a larger number of Telstra's exchanges.
>
> These outcomes highlight the benefits that are possible through infrastructure-based competition. Whereas the initial benefits of the current telecommunications regulatory regime were almost entirely due to competitors entering at the retail level and making use of regulated interconnection to drive down retail costs, the more competitive, innovative areas are those in which competitors have built their own networks, rather than just reselling space on Telstra lines.[10]

Recently, it has been observed that facilities-based competition, particularly through predicted take-up of the ULLS, is likely to develop over the coming years. Telstra has predicted that take-up of the ULLS will reach 1.8 million lines within three years.[11] Several competitors to Telstra have begun to invest in ULLS-enabling technology, while others have announced and/or are in the process of commencing their roll-outs. In particular, iiNet recently stated that it had 186 DSLAMs installed in exchanges, with almost 75,000 customers on ULLs.[12] Primus' roll-out is also underway, with over 130 DSLAMs installed and more than 40,000 customers on ULLs.[13] Optus has recently announced that it plans to roll-out DSLAMs to a sufficient number of exchanges to enable it to engage in facilities-based competition for 2.9 million end-users.[14]

The LCS may or may not have provided an effective stepping stone towards these developments. Competitive entrants are not able to break-even by reselling bundled local calls and line rental. Nevertheless, competitors are active in the retail voice market, and they do utilise the LCS as part of their retail market offerings. Further, some of these retail market competitors are those who have announced and/or are rolling out ULLS enabling investments.

However, it has been argued that the LCS service may deter movement towards a facilities-based approach where it dampens incentives for adopting a ULLS-based strategy. Given this, 'whether the LCS remains a complement to a facilities – based

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10 Ed Willettt, Commissioner, speaking at the AFR Fourth National Infrastructure Summit, Sydney, August 2005. The speech is available from the ACCC website,www.accc.gov.au

11 Ms Kate McKenzie, *Senate Estimates - Environment, Communications, Information Technology and the Arts Committee*, 31 October 2005, p. ECITA 123. Telstra's estimate was dependent on a range of assumptions regarding price and non-price factors, which were not fully disclosed.

12 iiNet, *January iiNews*, available at http://www.iinet.com.au/news/news_0106.html.

13 G. Lynch, *Primus says it will beat 2005 DSL target, as on-net gross margins surge to 50%*, Communications Day, Iss 2662, 3 November 2005, p. 1.

14 See: http://home.singtel.com/news_centre/news_releases/2005_09_22.asp.

approach or whether it has become a substitute or disincentive to infrastructure' remains a relevant question in certain circumstances.[15]

Alternatively, the growth of broadband, the impact of alternative networks/technologies and arrival of VoIP may provide an alternative path towards facilities-based competition.

Some of the submissions question the relationship between service and facilities-based competition from an entirely different perspective, posing the question as to whether service competition should be seen as an end achievement or good in its own right and should not be assessed only in terms of its ability to stimulate facilitates-based competition.

5.1.2 Responses to the discussion paper

AAPT

First, AAPT states that:

> Recent documents by the ACCC and the Discussion Paper in particular have expressed a bias towards the development of what is called "'facilities-based competition'.[16]

AAPT contends that this 'bias' is inconsistent with the objectives of the TPA because it misrepresents the historical context of deregulation of the industry, and promotes inefficient investment.[17]

Second, AAPT suggests that the LCS declaration has played an important role in promoting competition in the long distance telephony market:

> While some of the competition in international markets is now being led by the calling card industry, the role of the LCS in promoting competition in the long distance market must not be understated.[18]

AAPT believes that this role is reason enough to continue the LCS declaration.

Third, AAPT suggests that the definable local telephony market exists only as a consequence of regulatory decisions, and:

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15 ACCC, *Local Services Review 2005*, Discussion Paper. April 2005, p. 3.

16 AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 3.

17 ibid.

18 ibid., p. 8.

> …has no inherent distinction in the production technology underpinning it, nor in any customer demand characteristics other than that imposed by regulation.[19]

Australian Communications Network Pty Ltd (ACN)

ACN states that:

> ACN has consciously and consistently chosen to be a non-infrastructure based provider in all markets in which it operates so that it can focus its efforts on those elements of the supply of communications services where it has a competitive advantage – customer acquisition & marketing, service provisioning, billing & payment and customer care.[20]

ACN believes that the LCS in combination with competitive long distance and other services has provided consumers with enhanced benefit and choice, although this is beginning to falter.

ACN argues that:

- the only realistic competitive alternatives to LCS are not true facilities-based competition but merely other types of access-based competition
- in the local/access context (at least outside CBDs), access-based competition actually promotes the LTIE to a greater extent than facilities-based competition.[21]

ACN also states:

> The LTIE are maximised by a situation in which infrastructure services are provided by the most efficient provider of that element – the natural monopolist, while non-infrastructure services are provided by the most efficient providers of those elements – resellers of the LCS such as ACN.

Competitive Carriers' Coalition Inc (CCC)

The CCC submits that a range of competitive entry models may be legitimately used, stating that:

> …some competitors might not wish to invest beyond what is necessary to establish a pure reseller business. As long as there is the opportunity for others to invest further, the CCC does not believe this should be discouraged.[22]

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19 ibid., p. 9.

20 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 1.

21 ibid., p. 2.

22 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 3.

The CCC also states:

> If a competitor can establish a position in the market as a pure reseller, they should be free to do so, and it should be acknowledged that this adds a useful element of competitive tension to a market, especially where facilities based competition is nascent.[23]

Optus

Optus signals its commitment to facilities-based competition, stating that:

> Facilities based competition provides for competitive pressures across a wider cost base than resale competition. It also allows for deeper product differentiation and greater innovation than resale competition.[24]

However, Optus also states:

> Where facilities based competition is not feasible, regulation may be warranted… A form of resale based regulation may also be required where infrastructure competition is uneconomic.[25]

Southern Phone Company (SPC)

SPC argues that a reseller role is the only possible option in some regional areas of Australia, stating:

> …there is no alternative technology currently available that can work economically, effectively and broadly in regional Australia. The problem remains that a small, widely dispersed market prevents the development of a satisfactory business case that relies on economies of scale to justify investment.[26]

Telstra

Telstra states:

> …a decision by the Commission not to extend the LCS declaration will promote competition by giving service providers the appropriate incentives to use and extend alternative infrastructure, and will also promote competition in the upstream local services market by encouraging other carriers to offer wholesale local services.[27]

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[23] ibid.

[24] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 3.

[25] ibid.

[26] Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 3.

[27] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 3.

5.1.3 ACCC's view

The ACCC has on a number of occasions put forward the view that effective competition involves facilities-based competition. Without independent rivalry it is difficult to see how the conditions of effective competition such as independent rivalry in the price/product/service package can be achieved. However, it is difficult to form clear conclusions on the basis of the available evidence and argument as to whether declaration of the LCS has provided a stepping stone to facilities-based competition.

As noted above, there are a number of competitors active in the retail voice market, and several of these competitors have announced and commenced ULLS-enabling investment. Accordingly, the ACCC is of the view that it is likely that the LCS has positively impacted on the incentives for such roll-outs. While, the exact magnitude of its impact remains difficult to determine, the ACCC continues to believe that the LCS continues to serve as an effective complement to facilities-based roll-outs by access seekers, and therefore to effective and sustainable longer-term competition.

Submissions have clearly stated that resale competition also plays an important role in providing resale competition on an ongoing basis in all regions where facilities-based competition is unlikely to be economic. In such circumstances retail competition can drive cost efficiencies and encourage innovation at the retail level by providing a level of competitive tension in the market which would otherwise remain absent.

Thus, the ACCC considers that the original justifications with respect to the stepping stone approach remain valid, and that ongoing facilities-based developments are likely to continue to be complemented by the continued declaration of the LCS. Further, the ACCC also agrees with submitters that the LCS is likely to have an ongoing role in providing an important level of competitive tension in the market in all regions where facilities-based competition is not likely to be economic.

6 Defining relevant markets

6.1 The ACCC's approach

As indicated in Section 2, section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives:

- promoting competition in markets for listed services
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users
- encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied.

Accordingly, to examine whether declaration would be likely to promote competition, the ACCC may consider both:

- the market in which the eligible service is or would be supplied; and
- the market or markets in which competition may be promoted (where these are separate markets).

In order to determine whether or not declaration is likely to promote competition in telecommunications markets, it is important for the ACCC to first understand the existing state of competition in the market within which the eligible service is provided and all other related markets. To make this assessment, it is necessary in the first instance to assess the boundaries of the markets in which the eligible service and other related services are supplied.

Once the boundaries of the relevant markets have been identified, the ACCC can then consider whether the state of competition in these markets will be enhanced by declaration of the eligible service. In this regard, where appropriate and where the ACCC considers it usefully facilitates its consideration of the matters under section 152AH(1) the ACCC has given consideration to the 'future with and without' test, expressed in the Sydney Airports case[28]. Under this approach, the ACCC considers

[28] *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

whether competition in identified markets would be likely to be further promoted with declaration as opposed to a structure where the service was not declared. Only by understanding market dynamics and the current state of competition in these markets can a meaningful vision of the likely future state of competition be understood.

In assessing whether the declaration of an eligible service is likely to promote competition, therefore, the ACCC undertakes the following analysis:

- first, those markets relevant to determining whether declaration will promote competition are identified

- second, the current state of competition and the dynamics that operate within these markets is assessed and if the current state of competition in any of these markets is found to be less than effective, an assessment is made regarding the extent to which competition would be promoted, or be likely to be promoted, in the future by declaration of the eligible service.

In the context of this inquiry, the ACCC is considering the declaration of two eligible services. That is, a wholesale line rental service as well as a local carriage service. The first stage of this analysis is undertaken below for the market(s) in which the eligible services and related services are provided, and the subsequent analysis of the current and likely state of competition is completed in subsequent sections.

6.2 Market definition

6.2.1 The ACCC's approach to defining relevant markets

In any declaration review, the identification of the relevant market is necessary as it provides the ACCC with a starting point from which to analyse the extent of competition in a given market and the possible need for regulation.

The market definition process begins by identifying the service under consideration and the firm(s) supplying that service.

In having regard to the markets which may be affected, the ACCC gives consideration to the markets in which the services are supplied as well as vertically-related markets. In telecommunications, the relevant market impacted by declaration could be upstream, downstream or at the same level.

Market boundaries incorporate all sources and potential sources of close substitution with which the firm supplying the service would compete. Section 4E of the TPA states:

> … 'markets' means a market in Australia and, when used in relation to any goods or services, includes a market for those goods or services and other goods or services that are substitutable for, or otherwise competitive with, the first mentioned goods or services.

As noted by the High Court:

> This process of defining a market by substitution involves both including products which compete with the defendant's and excluding those which because of differentiated characteristics do not compete.[29]

To identify services that are 'substitutable for, or otherwise competitive with' the services under consideration, the ACCC uses the "price elevation test". The logic is that the availability of close substitutes (on both demand and supply sides) constrains the ability of suppliers to profitably divert prices or the quality of services from competitive levels. The resulting market is the smallest area over which a hypothetical profit maximising monopolist could impose a small but significant and non-transitory price increase (SSNIP).

For newly deregulated utilities, where the industry has traditionally been organised as a vertically integrated government monopoly unresponsive to the relative efficiency of such structures, the ACCC must also consider the likely evolution of vertical relations and the scope for market transactions at various vertical stages.[30]

In addition, account must be taken of 'commercial reality' to ensure that the market which it defines accurately reflects the arena of competition. Specific industry characteristics must be considered. For example, it is argued that in the case of telecommunications the SSNIP test needs to take into account:[31]

- The extent of supply substitutability, incorporating the forward-looking extent of substitutability by different and/or emerging technologies.

- Significant complementarities in demand as well as scope economies in supply. Services may be supplied and demanded in a bundled form. With regard to demand, there are some circumstances where no independent demand for particular services (such as access) exists.

- The nature of competition in the industry where service performance and innovation is more relevant than price as a source of competition. In such cases

29 Queensland Wire Industries Pty Ltd. BHP Ltd (1989) ATPR 4—925, p. 50,008 per Mason CJ and Wilson J.

30 See paragraph 5.66 of the ACCC's *Merger guidelines*, June 1999.

31 Gual J, *Market Definition in the Telecoms Industry*, 2002, prepared for the European Commission (DGCOMP) under contract: COMP/2001/7050/PSE/02, p 47.

a concentration on cross-price elasticities may misrepresent the boundaries of a market.

These are all critical issues which must be resolved in the context of this review.

In identifying relevant markets, Part XIC of the Act does not require the ACCC to take a definitive or determinative stance on market definition as may be the case in a Part IV or Part XIB case.[32] The Federal Court also endorsed this approach in its decision to uphold the validity of certain broadcasting access declarations by the ACCC.[33]

Furthermore, over time, declaration itself might affect the dimensions of these markets, particularly in relation to the functional dimension. Accordingly, market analysis under Part XIC should be seen in the context of providing an analytical framework to examine how declaration would promote competition rather than in the context of developing 'all purpose' market definitions.

Set out below is a brief overview of the issues in market definition for the eligible services involving the four market dimensions:

- product
- functional
- geographic
- time.

6.2.2 Defining the market in which the wholesale line rental service is supplied

In examining the appropriate definition for the market in which this eligible service is supplied, it is appropriate to consider whether or not there is any basis for treating wholesale line rental as a separate service from the LCS.

6.2.2.1 Should line rental be treated as a separate eligible service?

Issues raised by the Discussion paper

In making the previous declaration decision, the ACCC noted that line rental and local calls were usually consumed together as a bundle at both the wholesale and retail levels. It was also acknowledged that purchasers of the LCS would be vulnerable to changes in terms and conditions associated with line rental. In effect, the LCS declaration was considered to be a de facto declaration of the line rental service given

[32] See ACCC, *Telecommunications services – Declaration provisions*, July 1999.

[33] Foxtel Management Pty Ltd v Australian Competition & Consumer Commission [2000] FCA 589.

the ACCC's determination that, where an access seeker took a bundle of line rental and local calls, the retail cost of line rental could be subtracted either from the LCS price or from the line rental price (the ACCC's power under its arbitration responsibilities reflected this methodology).

Since the declaration was made in 1999, new issues have arisen which have re-opened the discussion about the merits of declaring the line rental service. The Discussion paper stated that:

- it is likely that the retail price for line rental, which is currently the de-facto access price[34], is above the cost of providing the service. Access seekers are therefore likely to be paying above the costs of line rental, with the consequence of lost efficiency.

- a greater range of line rental related services (such as Messagebank) are now available, and access seekers would like to use a number of these services. The availability (or otherwise) of these services can have an impact on competition. On the other hand, line rental does not need to be provided with these services, and in fact it may be desirable to have a 'stripped down' access service where wholesale ADSL is to be used as a basis for VoIP local call service. This suggests that consideration should be given to the level of unbundling that is required.

- if TSLRIC pricing were to be used for the LCS it is not clear how line rental would be priced, but the expectation is that it should also be cost based which would require declaration.

- declaration of the line rental service may allow a broader range of bundled offerings to be available at the wholesale level, thereby allowing increased competition with Telstra's retail quantity discounts.

- the use of PSTN O/T to provide local calls would require more direct regulation of the line rental service.

In the broadest terms if the ACCC declared a combined line rental and local call service the advantage would be that the pricing of the two would be related and conditional (which mirrors the existing approach). However, the disadvantage would be that any access seeker interested in the line rental service alone would have to take the LCS, and this may not be part of their competitive strategy. Increasingly a line rental service is an input into a broad range of telecommunication products rather than just a

[34] Telstra's current undertaking subtracts line rental retail costs from the price of the LCS rather than from the line rental price.

complement to the LCS, and as such it may be that unbundling of access to these two services is more likely to promote the LTIE.

Overseas experience

In Europe, several national regulatory authorities have imposed wholesale line rental obligations on their fixed incumbent carriers over the past few years. These obligations were imposed by some regulators as a remedy to dominance and to foster competition in retail narrowband access markets. In other instances, it was introduced to promote competition in retail telephony markets.

Wholesale line rental (WLR) is a service designed to increase competition in the market for fixed telephony services. It gives competing service providers a means of providing a complete voice offering to end-users with a single bill.[35]

The European countries that have imposed WLR obligations on their fixed incumbent carriers are:

- the UK
- Denmark
- Norway
- Ireland
- Sweden
- France
- Italy and
- Portugal.[36]

In most instances, prices are regulated using a retail-minus rule, whereby avoidable costs are deducted from the retail line rental paid by end-users of the incumbent.

In Denmark, which has the longest experience with WLR in Europe, the WLR penetration increased in the first year from 12 per cent of the preselected customer base

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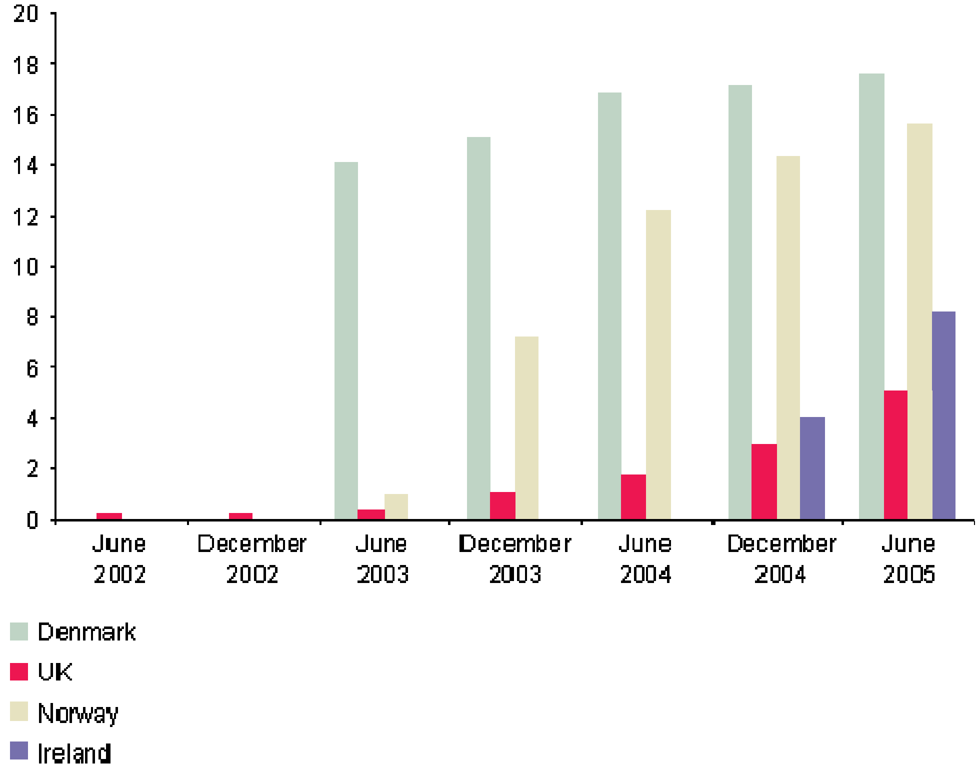
35 S. Abate and Z. Sielewicz, *The status of wholesale line rental in Europe*, 27 September 2005, www.ovum.com, p. 2.

36 C. Bachelet, *Wholesale line rental development and its impact on markets*, 8 November 2005, www.ovum.com, pp. 3-4.

in December 1999 to 40 per cent in December 2000. By December 2003 the WLR penetration of the preselected customer base had increased to 63 per cent.[37]

More generally, demand for the WLR product is evidenced by the rapid growth in its use as a proportion of the total number of lines, as demonstrated in Figure 1.

Figure 1 **WLR penetration as % of total number of lines**



Source: BT, Eircom, TDC, Telenor

Source: © Ovum 2005.[38]

Responses to the discussion paper

AAPT believes that the current service description is too narrow, stating that:

> The consequence is a service description for a service that cannot be acquired without also acquiring the line rental service. At the same time there are a range of additional services that must be acquired - such as calls to information services (1900) and reverse charge calls.

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37 S. Abate and Z. Sielewicz, op. cit., p. 4.

38 C. Bachelet, op. cit., p. 6.

> Finally, there is a problematic question of a range of other services that Telstra has chosen actively to exclude from its wholesale customer base - such as Telstra Messages 101.[39]

For this reasons, AAPT believes that the ACCC should:

> … [change] the service description to include the wholesale supply of the basic carriage service and all normally provided functionality associated with the service, including the ability to make and receive calls.[40]

Australian Communications Network Pty Ltd (ACN) believes that:

> Local calls, access and related bundled services (e.g. Call Waiting, Messagebank and Home Messages 101, 1900, 13, 1300 calls) should each be separately declared such that entrants can compete equally and flexibly with the incumbent's retail division in relation to non-infrastructure services across both bundled and unbundled offerings.[41]

ACN argues that Telstra's competitors are effectively forced to offer these services to their customers when using LCS, but must pay Telstra's retail rates, with no discount. In addition, ACN indicates that Telstra offers Home Messages 101 to its customers for free but does not make the service available for resale, thereby putting competitors at a disadvantage.

The Competitive Carriers' Coalition Inc (CCC) states:

> The CCC believes that basic access should be declared and made available at a cost-reflective price.
>
> There are no universal substitutes available for basic access and it is likely that there will be locations where substitutes never emerge. This is because in some locations the cost of acquiring ULLS and deploying independent DSLAM infrastructure is not justified by the addressable market. ULLS does not represent a universal substitute to basic access. Basic access therefore represents an enduring bottleneck.[42]

Optus states:

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39 AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 14.

40 ibid.

41 Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 5.

42 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 4.

> Whilst at the retail level, a perception of strong customer preference for one bill and for one service provider may justify such bundling, there appears limited reason as to why the access service should, by regulation, be provided as a bundle at the wholesale level.[43]

Optus suggests that declaration of a separate wholesale line rental service would increase opportunities for competition at the retail level. Optus argues that:

> Tying the regulated basic access service to any downstream service restricts the access seeker's flexibility to compete with Telstra on a resale basis… [as] the reseller is forced to pass on the standard bundle in the retail market consistent with the standard regulated price.[44]

Southern Phone Company (SPC) states:

> We believe declaration of the basic access service is desirable and that the wholesale price should be below the retail price in recognition of the costs of providing the first level fault and support service to the end user.[45]

Telstra states:

> In summary, Telstra submits that a basic access service should not be declared. Telstra has never in the past refused to supply basic access on reasonable terms and conditions. Furthermore, Telstra will increasingly face competition in the supply of basic access from alternative infrastructure and services, and there are already services declared for the purposes of providing line access including ULLS and LSS, which are consistent with the ACCC's objective of encouraging infrastructure competition.[46]

ACCC's response

There was good reason in 1999 to see local calls and line rental as part of the one service given that they were usually consumed as a bundle at both the wholesale and retail level. However, the ACCC considers that market changes since that time mean that such bundling is now less appropriate from a regulatory perspective.

The ACCC agrees with Optus' submission that there appears to be little reason why the provision of wholesale line rental should continue to be tied to a specific voice service.

Line rental is an essential input for the provision of both voice and data services. That is, a line rental service is a prerequisite to the purchase of an xDSL service in almost all circumstances, in addition to its function as a prerequisite for making and receiving

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43 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 9.

44 ibid.

45 Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

46 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 15.

voice calls.[47] As such, tying the line rental service to one specific downstream service would appear to inhibit an access seeker's ability to compete with Telstra on a resale basis, as the reseller is less able to differentiate the price or quality of its services, or the scope of its bundle. Resellers are effectively forced to replicate Telstra's bundling practices so as to pass on the regulated bundled price.

The ACCC therefore considers that there is little reason to continue the approach of bundling the line rental service with the LCS. Unbundling these services would not appear to entail any particular efficiency losses which would preclude such a move, and it would appear reasonable to suggest that there exists both actual and potential demand for an unbundled line rental service.

6.2.2.2 Product market

The delineation of the relevant product dimension of a market requires identification of the product (or service) in question, and the sources or potential sources of substitute products or services.

The product in question is Telstra's wholesale line rental service, provided via Telstra's ubiquitous customer access network (CAN) (primarily copper).

Telstra also owns a hybrid fibre coaxial (HFC) cable network that passes approximately 2.5 million homes, however this is not used to provide basic telephony services. Optus also owns an HFC network that passes approximately 2.2 million homes (most in similar areas as those passed by Telstra's HFC network), and does provide basic telephony over its network. Smaller fibre-based networks operate in the CBDs of most states and in some regional areas. However, none of the networks are close to ubiquitous, and are therefore unlikely to represent sufficiently effective substitutes so as to constrain Telstra's behaviour in the market, depending on geographic considerations as outlined in further detail below.

The CCC believes that there are no substitutes presently available for line rental. It suggests that:

> … roll outs of [ULLS-based] networks [are] limited and the ACCC has separately expressed concern about evidence of efforts by Telstra to frustrate these investments.
>
> … Mobile is not a substitute for fixed line calls according to research commissioned by Telstra which found 90 percent of those surveyed did not intended (sic) to cancel fixed line services because of the high cost of mobile or the use of fixed line for internet access.[48]

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[47] That is, both Telstra's wholesale and retail ADSL services require an active line rental service to be in place, as does the Line Sharing Service. The only exception to this is when an access seeker takes out the ULLS, and has full control of the range of services offered to the consumer via that ULL.

[48] Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 4.

Mobile substitution possibilities exist, as unlike the majority of other substitution possibilities mobile coverage is close to ubiquitous. However, independent research into the issue is not overly positive about the extent to which substitution has and will continue to occur[49]. While a segment of the market is willing to forgo connection to the fixed line network, it appears reasonable to conclude that the mass market is unlikely to 'cut the cord' to the fixed network for a range of reasons including status quo bias and the need to retain a line rental service to procure xDSL service. Thus, the scope for mobile services to act as effective substitutes for Telstra's wholesale line rental services would appear to be limited.

Data from the recently released Household Expenditure 2003-04[50] indicates that as expenditure on fixed telephone services increases across income quintiles, expenditure on mobile phones also increases but at a faster rate. Only at the top end of the market (a niche market) does mobile expenditure outstrip expenditure on fixed line services.

Average weekly household expenditure ($) by gross household income quintiles

	Lowest	**Second**	**Third**	**Fourth**	**Highest**	**All households**
Fixed telephone account	12.41	14.44	16.99	17.63	20.63	16.42
Mobile telephone account	3.21	6.36	11.39	13.61	19.48	10.81
Mobile phone charges (not account)*	0.61	1.16	1.58	1.98	2.45	1.55
Public telephone call (not account)**	0.11	0.17	0.16	0.13	0.39	0.19
Telephone and facsimile charges nec		0.01				
Total telephone and facsimile charges	16.34	22.14	30.12	33.35	42.94	28.97

* Definition used for pre-paid calls, ** Estimates,

49 Ovum, *Fixed-mobile substitution in Australia: does mobile have the winning hand?*, April 2005.

50 Australian Bureau of Statistics, *Household Expenditure Survey 2003-04*, Data Cubes, 6530.0.

The ULLS could potentially provide an alternative to Telstra's wholesale line rental product, by allowing access seekers to roll-out their own facilities with which to provide line rental and other products over Telstra's CAN. However, ULLS deployment is currently limited and is therefore unlikely at this stage to represent an effective constraint on Telstra. Further issues related to the future of ULLS deployment are discussed below with respect to temporal considerations as outlined in further detail below.

The ACCC is therefore of the view that, with the exception of CBD areas as outlined below, there are currently no widespread effective substitutes for Telstra's wholesale line rental service.

For service rather than facilities-based competition, add-on services appear to be an important issue for a number of LCS resellers. According to submissions received, some competitors see themselves as disadvantaged when competing with Telstra in the LCS market as they are unable to offer the same add-on services. However, line rental is also a prerequisite for some form of facilities-based competition in that it is necessary for the provision of ADSL broadband, and therefore for using wholesale ADSL as a basis for providing VoIP local call services.

There is therefore an issue as to whether or not certain add-on features should be incorporated into a broader line rental service description.

The CCC suggests that line rental should be offered as a separate declared wholesale service in two forms:

> Firstly, a "stripped back" basic access service based on a line that is not provisioned for voice or additional voice services. This service would be intended for access seekers wishing to deliver a wholesale ADSL service or a similar service that did not require voice features.
>
> A second voice enabled basic access service should be offered for those wishing to deliver LCS. This service should include access to the value-added services such as message bank that are integrated into the switch.[51]

Australian Communications Network Pty Ltd (ACN) believes that each service, and related bundled services should be separately declared. [52]

Southern Phone Company (SPC) states:

> There is no real point in developing a stripped down version. The end user has the choice of buying the access service and not using it for telephony services. The costs of maintaining and servicing the line would remain essentially unchanged.[53]

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[51] ibid., p. 6.

[52] Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 5.

Telstra also submits that:

> … the concept of a "stripped down" basic access service is unhelpful, as its meaning is unclear and it may or may not be feasible. Telstra is also not aware of any demand for such a service.[54]

The ACCC is yet to come to a firm view on the appropriateness of defining line rental to include 'add on' services as opposed to a 'stripped down' version. These issues are likely to be further examined in the fixed services review, prior to the ACCC coming to a final view on the appropriate market definition and subsequent service description.

6.2.2.3 Geographic market

The following discussion pertains to the geographic scope of both the wholesale line rental market and the LCS market.

The availability of substitutes for wholesale line rental and LCS varies substantially across different regions. In 2002, competition in the high demand CBD areas was considered sufficient to remove access obligations. As carriers develop their networks there will potentially be increasing competition in metropolitan areas. However, with the dispersion of the Australian population, competition in rural and regional Australia is considered a more distant prospect. Given this diversity, alternative geographic delineations of the market might lead to quite different outcomes, raising questions

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[53] ibid.

[54] ibid., p. 18.

about whether there should be regulation in some market segments and not in others, and whether the form of regulation should differ across geographic segments.

Current market conditions

In June 2004 there were multiple local access networks in CBD and metropolitan areas (notably Sydney, Melbourne, Brisbane, Adelaide and Perth).[55] About half of these carriers provided some level of access to other service providers. Nevertheless, even in these circumstances – when considerable retail competition is occurring – over 99 per cent of connections are to networks operated by Telstra **[c-i-c per cent]** and Optus **[c-i-c per cent]**.

With regard to provincial centres, several carriers have deployed local access networks in cities such as Wollongong and Newcastle in New South Wales, and Geelong, Bendigo, Mildura and Ballarat in Victoria. However, setting aside these specific areas, Telstra provides **[c-i-c per cent]** of connections in provincial areas.

In rural and remote areas, Telstra is the only carrier that operates in all states and provides copper and optical fibre local access networks (as opposed to satellite). In June 2004, approximately **[c-i-c per cent]** of subscribers connected to Telstra **[c-i-c per cent]** or Optus **[c-i-c per cent]** local access networks.[56]

Responses to the discussion paper

AAPT believes that the market should be viewed as national, and states:

> AAPT does not dispute that the availability of alternative infrastructure varies across geographic regions. However, AAPT does not accept that the market for local telephone services is competitive anywhere.[57]

AAPT suggests that the declaration of the LCS promotes competition in the market for long distance services, and that as a result:

> … the LCS needs to be declared for the whole of Australia as there is only a national market for these services.[58]

Further, AAPT argues that:

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[55] ACCC, *Telecommunications Infrastructure in Australia 2004*, June 2005, pp. 16-17.

[56] ibid.,, see tables 4, 5 & 6.

[57] AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 11.

[58] ibid.

> [Business] customers choose to acquire their telephony services frequently from one provider nationally for local and long distance service. The existence in one geographic location of competitive infrastructure does not guarantee access to that infrastructure to an alternative service provider.[59]

Finally, AAPT claims that the exemption from declaration of the LCS in CBD areas should be removed, because it believes that significant development of residential units has made alternate competitive infrastructure unsuitable.

Optus believes that the market should be defined on a geographical basis, and that the ACCC should:

> Exempt metropolitan areas from the declaration of the local carriage service (LCS) when 80% of exchanges in metropolitan bands have a competitor's DSLAM installed and in service. A competitive resale and wholesale market based on partial facilities-based competition will then be able to operate - hence regulation will not be in the LTIE.[60]

Further, Optus states:

> … in geographic areas where the TSLRIC of local calling exceeds the retail-minus (retail) cost (that is, in higher cost areas), non-Telstra access providers should be exempt from providing LCS access services to other parties. Such an exemption would likely stimulate competitive entry into the market through the ULLS rollout.[61]

SPC states:

> Should the ACCC consider modifying the declaration of LCS in relation to geographic segments it is essential the interests of regional Australia be protected by continued coverage by the declaration.[62]

SPC does not believe that the requisite economies of scale exist for competitive infrastructure to be developed in regional areas, and as such:

> … any LCS declaration must recognise the circumstances of regional Australia and allow a continued cross subsidy in service provision between regional and metro areas.[63]

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[59] ibid., p. 12.

[60] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 3.

[61] ibid., p. 8.

[62] Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 3.

[63] ibid., p. 4.

Telstra's submission, while making no explicit comments about geographical segmentation, emphasises the further growth in 'real and viable' alternative infrastructure since the 2002 exemption of the CBD areas from the LCS declaration.[64]

At the same time (and not necessarily consistent with the above statement) the cost differences occurring in different geographical areas are emphasised, as is Telstra's obligation to charge geographically averaged retail prices for local calls under the local call pricing parity scheme.

ACCC's response

In 2002 the ACCC made a decision to grant a declaration exemption from the central business districts of Sydney, Melbourne, Brisbane and Adelaide and Perth. The exact geographical boundaries of these areas were able to be defined by the boundaries of Telstra's CBD Exchange Service Area and the applicable local zone relevant to these CBD Exchange Service Areas.[65] The ACCC came to the view that there was sufficient alternative local access infrastructure and declared services (local PSTN originating access and ULLS) for originating local calls in these areas either being used, or that could readily be used, by alternative carriers and carriage service providers to act as a constraint on the prices that Telstra would be able to charge. As a result of this exemption, the de facto declaration of line rental was also effectively removed.

The ACCC considers that there is every reason to believe that this conclusion still holds. Average prices for local calls for 'other' business (large businesses) continues to fall (although in 2003-04 the average price paid by other business consumers for local calls decreased by 1.6 per cent, compared to a 10.8 per cent decrease in 2002-03)[66].

However, similar conclusions are unlikely to hold outside these five CBD regions under current market conditions. While there are some infrastructure options in limited regional areas, and Optus has indicated a possible way of carving out some metropolitan areas based upon levels of DSLAM rollouts, this is a paucity of options in comparison to those to be found operating within the exempted CBD areas.

The ACCC considers that there is therefore no basis for "carving out" random areas from the national market at this stage. While the availability of telecommunications infrastructure in metropolitan compared to regional and rural Australia may be

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[64] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 9.

[65] ACCC, *Future Scope of the Local Carriage Service - Final Decision*, July 2002. p13

[66] ACCC, *Changes in the prices paid for telecommunications services in Australia 1997-98 to 2003-04*, March 2005, p96. The 'other business' category is generally comprised of large business that fall outside the respective carriers' definitions of small business. It would be expected that other business was concentrated in the CBD area.

relatively more abundant, this does not mean that what is available in metropolitan areas meets the requisite threshold of effective substitutability. Standard geographical divisions such as metropolitan, regional and rural do not currently provide a useful or informative way to segment the market.

Instead, with the exception of the five CBD areas the wholesale line rental market should be seen as a national market. Unlike the five CBD areas it is not possible to tightly define other geographical areas that are well serviced with alternative access infrastructure that would be sufficiently effective substitutes for Telstra's wholesale line rental service and LCS. However, the ACCC is likely to further consider, particularly in the context of the fixed services review, forward-looking indicators of the development of competition in a geographic context in order to determine where, and when, further geographic exemptions from declaration for this service would be warranted. The ACCC continues to believe that in circumstances where sufficient competition was found to exist in specific regions, the exemption process provides a better mechanism for the removal of declaration rather than incremental alterations to the service description.

6.2.2.4 Functional market

The functional dimension of a market refers to the activity, or group of activities involved in the supply chain. To define the functional market, the vertical stages of production and/or distribution need to be identified by considering whether there are efficiency gains from vertical integration, and whether substitution possibilities at adjacent vertical stages can constrain the exercise of market power. Where there are overwhelming efficiencies of vertical integration between two or more stages, it is inappropriate to define separate functional markets.

Access and the local call service have been seen as a single product because the local call service cannot be provided in the absence of a line rental service. However, from a functional perspective the local call service supply is the next stage from the supply of line rental. In this way access or wholesale line rental can be seen as an adjacent stage to the actual local call service within the overall vertical supply chain.

There appear to be no overwhelming efficiencies from vertical integration, indicating that there are various wholesale functional markets and their substitutes as well as various retail functional markets that should be considered as part of the relevant market.

6.2.2.5 Temporal market

The temporal dimension of the market refers to the timeframe over which substitute services could potentially exert a competitive constraint on the pricing and output behaviour of a provider of the eligible service. A timeframe that is too short may exclude alternatives on the demand or supply side that are actually constraining conduct in the market in question. Whereas, one that is too long risks including those services which are not effectively constraining behaviour currently or for the foreseeable future.

The ACCC noted in the Discussion Paper that the potential for viable supply substitutes (both those currently available and those that could feasibly be rolled out in the near future) could impact on its declaration decision with regards to the LCS over time. Similar concerns exist with respect to any declaration decision for a wholesale line rental service. An understanding of the feasible timeframes for the development of facilities-based and access-based alternatives to the eligible service is required to form a view as to the likelihood of these potential substitutes to act as effective substitutes such that they could constrain Telstra's conduct.

With the exception of those areas already excised from the LCS declaration, most of Australia is still almost exclusively reliant on Telstra's fixed line network for the provision of line rental. Nevertheless, there are technologies currently available and other technologies in prospect which may be effective substitutes to Telstra's network in the future. However, the development and use of these alternatives for the provision of the LCS is currently subject to considerable uncertainty.

Responses to the discussion paper

AAPT is sceptical of the benefits of infrastructure based competition, and as a consequence the development of realistic supply substitutes.

AAPT does not believe that the ULLS is providing significant competition in the market for local telephony services, and expresses its view that:

> Telstra will progressively replace the copper network, installing fibre between existing exchanges and small street-based copper centres. The installations in exchanges by competitors attempting to access the ULL will be rendered useless.[67]

ACN states:

> The only realistic competitive alternatives to LCS are not true facilities-based competition but merely other types of access-based competition.[68]

ACN believes that ULLS, LSS and wholesale ADSL (for VoIP provision) ultimately rely on Telstra's bottleneck facilities and as such do not provide true facilities-based competition.

Further, ACN asserts that none of the range of alternatives to LCS

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[67] AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 6.

[68] Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 2.

> … provide the realistic possibility of additional facilities-based competition in local calls and access in the short or medium term.[69]

The CCC believes that there are no substitutes presently available for line rental. It suggests that ULLS roll-outs are limited and that mobile services are not a substitute.[70]

Optus states that:

> [its] business plans may allow ULLS roll-out to a number of Band 1 and 2 exchanges within the next three years but these are uncertain…
>
> … Optus understands that other carriers also have similarly uncertain rollout plans to exchanges in Band 2 areas.[71]

Optus further indicates that under certain conditions it would enter into a 'Network Development Deed' whereby it would commit to developing ULLS infrastructure within a three year period.

SPC states:

> … we have sought alternatives to the "last mile" with enthusiasm. This has included trialling Wireless Local Loop and Power Line Carrier technology. While imperfect, both of these technologies can be made to work.
>
> However, there is no alternative technology currently available that can work economically, effectively and broadly in regional Australia.[72]

As a result, SPC concludes that:

> Unless widespread, competitive, local access infrastructure is developed (which we believe is unlikely in regional areas) the declaration should remain in place indefinitely.[73]

Telstra believes that the LCS declaration should be discontinued, but argues that if it is continued:

> … such a declaration should be reviewed again in 2 years (that is, June 2008). Due to the dynamic market conditions and the rapid expansion of alternative infrastructure and services, it

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69 ibid., p. 3.

70 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 4.

71 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation,* July 2005, p. 8.

72 Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 3.

73 ibid.

is likely that any of the ACCC's current residual concerns would be addressed within that period. [74]

ACCC's view

The ACCC considers that the range of responses confirm the current level of uncertainty regarding the development of competitive infrastructure platforms and services. Telstra believes that sufficient substitution possibilities exist within the market, or that rapid expansion will occur within the next two years. The other submissions indicate a much higher level of scepticism than Telstra about the availability of substitutes outside CBD areas.

Wireless broadband development plans are subject to considerable uncertainty and wireless broadband networks, in the short to medium term, are likely to continue to be niche competitors. While this assessment may change in the future, the ACCC currently does not envisage that these networks will develop as effective substitutes for the eligible service on a widespread geographic basis in the next few years.

Much has been made of the likely future substitution of mobile for fixed line services, as unlike the majority of other substitution possibilities mobile coverage is close to ubiquitous. However, on the evidence available while some level of substitution is occurring (which would seem more likely in small households and amongst a younger demographic), mobile phones can equally and have usually been seen as a complement to fixed line services. There appears to be little indication as to whether the role of mobile services is likely to change in the coming period, and there certainly appears to be research available (as outlined by the ACCC above, and as submitted by the CCC) to suggest that mobile services are unlikely to act as substitutes for fixed services for the mass market.

Telstra's evidence on this and other substitution issues can be described as mixed. For example, when arguing in favour of the strength of fixed to mobile substitution, Annexure D to Telstra's submission states:

> The introduction of bucket "capped" plans… is expected to result in significant shifts from fixed to mobile telephony. Contrary to the Commission's belief that there is no evidence of any significant shifts from fixed to mobile telephony to date, Telstra's analysis indicates that more than 100,000 end users have substituted their fixed line services for mobile services over the 12 months ending March 2005.[75]

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[74] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 18.

[75] Telstra Corporation Limited, Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005', 28 June 2005, p. 65

However, when arguing in favour of its preferred provisioning rules with respect to the PIE II model and other fixed services, Telstra has made the following statements about fixed to mobile substitution:

> One potential cause for the recent drop in CAN demand is mobile access substitution. However, as the saturation of the mobile market occurs in Australia… the impetus for fixed lines to be abandoned can be expected to slow. That is, those who are going to switch from fixed to mobile access services, are likely to have done so already.
>
> Fourth, the increasing penetration of DSL services… also mitigates the effect that mobile substitution might have on the demand for CAN services.[76]

Further, with respect to changes likely to have arisen as a result of the increasing take-up of broadband services:

> Another cause for the recent drop in [sic] for CAN services is a decline in the demand for second lines for a dial-up Internet connection, given the availability of ADSL. However, again customers that once had a second line for dial-up Internet are likely to have been the early adopters of ADSL and are also likely to have already disconnected their second line… Customers who previously had a second line for dial-up Internet are, therefore, likely to represent a large proportion of the decline in PSTN services over the last three years since ADSL has become available. However, since the majority of these customers are likely to have already disconnected their second lines, they will not contribute to a further decrease in the demand for CAN services in the future.[77]

Without forming a view as to reasonableness of Telstra's conflicting statements, the ACCC notes that Telstra's inability to form a definitive view as to the reasons for recent changes in demand for CAN services, as well as an inability to accurately predict the future paths for these services and the impacts of various substitution possibilities reinforces the ACCC's belief that there exists a reasonable level of uncertainty regarding the extent of fixed to mobile substitution. This, combined with the limited independent analysis available, suggests that while there has been, and will likely continue to be marginal substitution between fixed and mobile services, this is not enough for the ACCC to conclude that mobile services are likely to be effective substitutes in the national market for fixed services in the coming period.

While Optus' network is used for the provision of local calls to a limited extent, its ultimate potential as a substitute is limited by its geographic coverage (approx 2.2 million homes). Further, Optus has not indicated any plans to expand the coverage of this network, and accordingly this network is unlikely to act as an effective substitute to the eligible service for all but a limited market segment for the foreseeable future.

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[76] Telstra Corporation Limited, *Telstra's submission in support of the ULLS monthly charges undertakings dated December 2005*, Annexure E – Network Costs, pp. 12-14.

[77] ibid, p. 13.

VoIP is potentially a significant substitution possibility for calling services in the short to medium-term, and arguably broadband connections capable of providing VoIP services could potentially be viewed as substitutes for Telstra's line rental service. However, it remains difficult to predict the future of VoIP services, and there are no firm forecasts available in relation to its take-up by residential consumers. Further, VoIP take-up would be unlikely to result in substantial bypass of Telstra's network, as the majority of current broadband connections are provided over Telstra's network, and competing broadband networks such as Unwired are not ubiquitous and currently not heavily subscribed as a proportion of the total market. As at 30 September 2005, approximately 73% of total broadband connections were supplied via ADSL over the CAN,[78] and Telstra's current practices require an active line rental service in order to purchase ADSL. As a result, the ability of broadband connections to act as effective substitutes for Telstra's line rental service would appear to be limited, as Telstra appears to have both the incentive and ability to affect the take-up of residential VoIP services in many regions and therefore hinder its ability to act as a substitute for its line rental and voice services.

As competitors move to take up ULLS services, these services are increasingly likely to be able to act as supply substitutes for line rental. Therefore, any consideration as to the impact of the ULLS on the declaration of line rental rests heavily on current and future projected rates of take-up of the ULLS. Additionally, the geographic dispersion of ULLS lines would appear to be an important factor.

At this stage, predictions as to the rate of take-up of ULLS lines are subject to uncertainty. A number of competitors have deployed DSLAM infrastructure to Telstra's exchanges. However, the current level of deployment of DSLAMs is still limited, and as outlined by the submissions above, timeframes for announced but not yet commenced/completed deployments are also unclear. For example, Optus has recently announced that it plans to roll-out DSLAMs to a sufficient number of exchanges to enable it to engage in facilities-based competition for 2.9 million end-users,[79] however full details, including geographic dispersion of DSLAMs (other than at a very aggregated level), are not publicly available.

While DSLAM roll-outs may facilitate ULLS take-up by increasing the addressable market for ULLS-based competitors, actual rates of ULLS take-up (and their inter-relationship with ongoing deployment strategies) in the short to medium term are unclear. Actual take-up may not be sufficient within a reasonable time period to provide an effective substitution possibility for Telstra's wholesale line rental service,

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78 ACCC, *Snapshot of Broadband Deployment as at 30 September 2005*, p. 2.

79 In addition to 1.4 million end-users passed by its HFC network, for a total number of end-users in excess of 4 million. See: http://home.singtel.com/news_centre/news_releases/2005_09_22.asp.

particularly in geographic regions where widespread ULLS deployment is less likely to take place. In this regard, it is noted that the majority of DSLAM deployments are likely to occur in metropolitan regions, and thus it is unlikely that the ULLS will provide a competitive constraint to Telstra across the broader national market.

Predictions regarding ULLS deployment are further compounded by proposed changes to Telstra's network architecture, particularly fibre-to-the-node plans and associated network modernisation provisions contained within Telstra's recently submitted ULLS undertaking. These issues will be further examined in the ACCC's wider review on fixed services and its assessment of Telstra's undertaking.

The ACCC continues to believe that, under reasonable market conditions, ULLS deployment remains one of the more favourable paths towards sustainable competition in the market. However, the above discussion highlights that, for the purposes of market definition, it is both conservative and reasonable to conclude that ULLS take-up is not likely to effectively constrain Telstra's conduct with respect to the national wholesale line rental market.

However, rapid uncertain change within the industry means that speculation about longer term changes becomes just that – highly speculative – and there are often as many views as there are industry positions. Past predictions about the role that developing technologies will play have often been misguided. Also, the role that possible substitutes may play in the future needs to be seen in the context of what is currently the most important characteristic of local telecommunications – the dominance of Telstra.

The ACCC therefore agrees with Telstra that the appropriate time frame for consideration of substitution possibilities is two years from 1 July 2006. While a range of alternative network and access solutions could potentially develop in the coming period, there is a sufficient level of uncertainty regarding these developments to preclude a conclusion that these future substitution possibilities would effectively constrain Telstra's decisions regarding the provision of wholesale line rental. In view of these circumstances, the ACCC believes that the appropriate timeframe for the declaration of the LCS is a period of two years starting 1 July 2006. After that it seems reasonable to suggest that a review of the range of substitutes available to the wholesale line rental service may be required to determine whether any are sufficiently effective so as to alter the ACCC's view on the appropriate definition of the market.

6.2.2.6 ACCC draft view

Based on the various dimensions of the market considered above, the ACCC considers the relevant market is the national wholesale line rental market. However, the continued exemption of the CBD areas should be allowed as the characteristics of these markets are uniformly different from other parts of the national market.

6.2.3 Defining the market in which the wholesale local carriage service is supplied

6.2.3.1 Product market

The delineation of the relevant product dimension of a market requires identification of the product (or service) in question, and the sources or potential sources of substitute products or services.

In the case of the LCS, the relevant service for consideration is the wholesale supply of local call services to carriers or carriage services providers by Telstra or other carriers. In examining the impact on competition the ACCC's inquiries are concerned with the supply of these services to other carriers or carriage service providers who provide local calls to end–users. A local call is defined as a call where both the calling and called party are located in the same standard zone.[80]

The definition includes wholesale services which other carriers and carriage service providers could purchase from Telstra or other carriers to supply retail local call services to end-users.

While facilities-based competition in the mobile telecommunications market has narrowed the gap between mobile and fixed voice services, increasing the likelihood that more significant fixed to mobile substitution will occur, it is doubtful that the current extent of substitution is presently sufficient to treat fixed line and mobile local calls as being interchangeable. Telstra's most recent results suggest significant declines in the number of local calls being made, and point to a range of reasons as to why this may be the case.[81] These reasons are broadly similar to those identified above in section 6.2.2.5, ie. fixed to mobile substitution and internet substitution. However, as noted above, while pointing to a range of factors, Telstra has not quantified the relative impacts of these factors, and its evidence as to likely future substitution trends is mixed.

Accordingly, information regarding fixed to mobile substitution currently available is too highly aggregated and/or inconsistent to form firm conclusions on the extent to which the decline in local calls can be directly attributed to mobile product substitution effects, and therefore whether or not to include their wholesale equivalents in the relevant market definition. While fixed to mobile substitution is likely to be relatively more observable for calling products than line rental, given many consumers unwillingness to 'cut the cord', estimates on the rate of substitution on calling products in Australia are not reliable. Further, relative to other calling products, the untimed nature of local calls is likely to inhibit widespread substitution to mobile equivalents.

[80] The term 'standard zone' is defined in s.227 of the *Telecommunications Act* 1997.

[81] Telstra Corporation Limited, *Half-year report for the half-year ended 31 December 2005*, February 2006, p. 12.

In addition, competitive responses from well-positioned fixed voice operators are likely to impact on call substitution, including accelerated introduction of capped plans, more extensive bundling with other fixed services such as broadband internet (identified by Telstra above as a limiting factor for substitution), more functional fixed handsets, fixed-mobile convergence products, etc. At this stage, the ACCC believes that while there has been a higher level of substitution observed for calling products than access, it is appropriate to conclude that mobile services are not currently effective substitutes for the LCS.

Limited business use is currently made of PSTN originating and terminating access (O/T) in making local calls. With regulatory changes, greater use could perhaps be made of this service in providing local calls, and PSTN O/T could potentially be a substitute for the LCS.

The use of the PSTN O/T to provide local calls would require access seekers to increase their interconnect capacities including transmission systems from their switches to the POI and add switch points on their switches. Telstra claims that it would also have to invest many millions of dollars in its PSTN to augment this traffic.[82]

AAPT suggests that the ACCC should conduct a public hearing in relation to an alternative PSTN model, stating:

> AAPT shares the ACCC's intuition that greater use of the Local PSTN OTA in conjunction with over-ride codes or the use of an alternative pre-selection determination might be appropriate.[83]

Other than AAPT, there appears to be little interest from competitors for use of PSTN O/T for local calls. As a substitute for the LCS in a national market (excluding the relevant CBD areas), the use of PSTN O/T for local calls in provincial and rural markets would be more costly. It would also be more costly for long-held calls. Accordingly, it is the ACCC's draft view that use of the PSTN O/T to provide local calls is unlikely to represent an effective substitute to the LCS in the short to medium term across the majority of the national market. The ACCC will, however, examine this further in the context of the fixed services review prior to finalising its views on this issue.

The uptake of the ULLS could also have a significant impact on the use of the LCS, and as such measures that impact on this uptake need to be considered. While it is the ACCC's draft view that substitution possibilities provided by the ULLS are not effective substitutes for the LCS at the current time, as uptake increases it will

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82 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 35.

83 ibid., p. 15.

increasingly raise questions with regards to both Telstra's (and ULLS-based competitors) ability to provide the LCS as currently defined. Further, as broadband access speeds and penetration increase, the use of VoIP technology for both local and other call services becomes more viable as an alternative to the traditional circuit–switched network. These issues are also likely to be further canvassed in the fixed services review.

6.2.3.2 Geographic market

In 2002 the ACCC made a decision to grant a declaration exemption from the central business districts of Sydney, Melbourne, Brisbane and Adelaide and Perth. The exact geographical boundaries of these areas were able to be defined by the boundaries of Telstra's CBD Exchange Service Area and the applicable local zone relevant to these CBD Exchange Service Areas.[84] The ACCC came to the view that there was sufficient alternative local access infrastructure and declared services (local PSTN originating access and ULLS) for originating local calls in these areas either being used, or that could readily be used, by alternative carriers and carriage service providers to act as a constraint on the prices that Telstra would be able to charge.

In line with its above discussion with respect to wholesale line rental, the ACCC's view is that with the exception of the five CBD areas the wholesale LCS market should be seen as a national market. Unlike the five CBD areas it is not possible to tightly define other geographical areas that are well serviced with alternative access infrastructure that would be sufficiently effective substitutes for Telstra's wholesale LCS so as to act as constraints on the prices that Telstra would be able to charge. However, the ACCC is likely to further consider, particularly in the context of the fixed services review, forward-looking indicators for the development of competition in a geographic context in order to determine where, and when, further geographic exemptions from declaration for this service would be warranted.

6.2.3.3 Functional market

The functional dimension of a market refers to the activity, or group of activities involved in the supply chain. To define the functional market, the vertical stages of production and/or distribution need to be identified by considering whether there are efficiency gains from vertical integration, and whether substitution possibilities at adjacent vertical stages can constrain the exercise of market power. Where there are overwhelming efficiencies of vertical integration between two or more stages, it is inappropriate to define separate functional markets.

Access and the local call service have been seen as a single product because the local call service cannot be provided in the absence of a line rental service. However, from a functional perspective the local call service supply is the next stage from the supply of

[84] ACCC, *Future Scope of the Local Carriage Service*, Final Decision, July 2002. p13

line rental. In this way access or wholesale line rental can be seen as an adjacent stage to the actual local call service within the overall vertical supply chain.

There appear to be no overwhelming efficiencies from vertical integration, indicating that there are various wholesale functional markets and their substitutes as well as various retail functional markets that should be considered as part of the relevant market.

6.2.3.4 Temporal dimension of the market

The temporal dimension of the market refers to the timeframe over which substitute services could potentially exert a competitive constraint on the pricing and output behaviour of a provider of the eligible service. A timeframe that is too short may exclude alternatives on the demand or supply side that are actually constraining conduct in the market in question. Whereas, one that is too long risks including those services which are not effectively constraining behaviour currently or for the foreseeable future.

The ACCC noted in the Discussion Paper that the potential for viable supply substitutes (both those currently available and those that could feasibly be rolled out in the near future) could impact on its declaration decision with regards to the LCS over time. An understanding of the feasible timeframes for the development of facilities-based and access-based alternatives to the LCS is required to form a view as to the likelihood of these potential substitutes to act as effective substitutes such that they could constrain Telstra’s conduct.

Telecommunications is a rapidly evolving industry driven by significant technological innovation. Considering the potential for the industry to be transformed with new technology, it is important to take a longer term view to understand the role that potential substitutes and competing technologies may play.

The ACCC raised the issue of the use of PSTN O/T to provide local calls suggesting that this could be achieved either by a preselection determination or by altering the service description for PSTN O/T. This decision has yet to be made, and is potentially contingent on further work to be conducted with respect to the fixed services review.

However, even if the necessary regulatory changes were made to facilitate the use of PSTN O/T for local calls Telstra claims it will be unlikely that it would be an effective substitute for the LCS within the short to medium-term. Telstra claims that significant infrastructure roll-outs would be required to accommodate the usage of PSTN O/T to provide local calls. The infrastructure that access seekers would be required to provide would have to be supported by significant investment by Telstra to augment the PSTN to accommodate the increase in traffic. Such investment may entail extended deployment periods, and thus the ability of PSTN O/T to serve as an effective substitute in the short to medium term may remain limited.

The ACCC notes, however, recent proposed changes to Telstra's core network architecture, and considers that these changes may raise further questions regarding both the feasibility and efficiency of using the PSTN O/T for providing local calls. The ACCC expects to further examine these developments in the context of its fixed services review.

VoIP is potentially a significant substitution possibility for calling services in the short to medium-term. VoIP is a single expression used commonly to refer to a range of voice transmission options as alternatives to the PSTN. As such, it is difficult to predict its take-up with any certainty, and there appear to be no reliable forecasts available. Telstra statistics note that as little as 2.2 per cent of consumers have made a VoIP call by the third quarter of 2005, and only 3 per cent have intentions to make a VoIP call.[85] These statistics do not clarify whether consumers intend to use these calls as substitutes for local calls, or whether they are willing to cease making local calls or other PSTN calls wholly or in part as a result of the availability of VoIP. Telstra's statistics do however point to increasing numbers of 'VoIP' households, with VoIP penetration rising from 1.5 per cent in 2005 to 5.8 per cent in 2008.[86] However, again these statistics provide no guidance as to the extent to which households are likely to give up PSTN access or calling services as a result of VoIP's increasing availability. Further, Telstra's surrounding presentation indicates that Telstra itself will be a guiding force behind the adoption of this technology. Therefore, at this stage the ACCC does not envisage that VoIP-based calling services are likely to represent a viable or widespread alternative to local calling services for the national market within the likely period of declaration.

Much has been made of the likely future substitution of mobile for fixed line services, as unlike the majority of other substitution possibilities mobile coverage is close to ubiquitous. However, on the evidence available while some level of substitution is occurring (which would seem more likely in small households and amongst a younger demographic), mobile phones can equally and have usually been seen as a complement to fixed line services, and it is not clear the extent to which its role as a substitute is likely to expand in the coming period.

However, rapid change within the industry means that speculation about longer term changes becomes just that – highly speculative – and there are often as many views as there are industry positions. Past predictions about the role that developing technologies will play have often been misguided. Also, the role that possible substitutes may play in the future needs to be seen in the context of what is currently

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85 Ms Carol White, Telstra Corporation Ltd, *View of an Integrated Provider*, Presentation to 2nd ACIF VoIP Forum – Identifying the Missing Links, 6 December 2005, p. 4. Available at: http://acif.org.au/__data/page/14630/Presentation_8._Carol_White_Telstra_-_Case_Studies.pps.

86 ibid.

the most important characteristic of local telecommunications – the dominance of Telstra.

The ACCC agrees with Telstra that the appropriate time frame for consideration of substitution possibilities is two years from 1 July 2006. While many potential substitutes exist, given the current limited take-up, technological issues about quality of service (for VoIP) and the dependence of alternative services on gaining line rental from Telstra, the ACCC considers it would be difficult to conclude that there are likely to be any effective substitutes in the market for the LCS in the next few years.

In view of these circumstances, the ACCC believes that the appropriate timeframe for the declaration of the LCS is a period of two years starting 1 July 2006. After that it seems reasonable to suggest that a review of the range of substitutes available to the LCS may be required to determine whether any are sufficiently effective so as to alter the ACCC's view on the appropriate definition of the wholesale market for the LCS.

6.2.3.5 ACCC draft view

Based on the various dimensions of the market considered above, the ACCC considers the relevant market is the national market for providing local calls to other carriers and carriage service providers via the local carriage service or other means in the national market, with the exemption of those CBD areas covered by the current exemption to the LCS.

The current LCS service description allows an access seeker to purchase an end-to-end local call except where that local call originates in the CBD area of Adelaide, Brisbane, Melbourne, Perth or Sydney.

6.2.4 Defining the downstream market for retail voice services

6.2.4.1 Should the relevant downstream markets for line rental and local calls be defined narrowly or as a broader fixed voice services market (including fixed to mobile, national and long-distance calls)?

The downstream markets for each of the eligible services are, at their narrowest the retail markets for line rental and local calls. However, it is unclear whether this market should be narrowly defined, or broadly defined to also include the other fixed line services (fixed to mobile, national and long-distance calls).

With regard to the downstream market, it is essential to ask whether line rental or local calls could be considered as separate services and independent of other call services. On the one hand, local calls are not a direct substitute for other types of fixed calls – long distance for example. However, it is also the case that carriers who provide line rental and local call tend to bundle these with long distance calls.

Telstra states:

> … even local calls and basic access taken together ("Local Services") do not constitute a separate product market. Rather, the relevant product market is likely to be at least a broader PSTN or fixed telephony market, including Local Services, local and international long distance calls, as well as fixed to mobile calls.[87]

Telstra provides the following arguments in support of its position:

- Other telecommunication providers only sell fixed line services as a bundle with pre-selectable services, indicating that there is likely to be either a demand or supply-side cluster.

- Expenditure on telephony services specifically is low. Total expenditures are not likely to be high enough to justify the cost of unbundling.

- Total expenditure tends **not** to be dominated by the purchase of any one service, suggesting that the price of the full service bundle is more important to consumers than the price of a particular service.

- There appear to be supply-side economies of scope associated with bundling. Telstra argues that the most important evidence of economies of scope is service provider pricing plans and availability. Further, some service providers offer discounts only to customers purchasing a bundle of fixed line services.[88]

A critical question to resolve is whether the demand for bundled products (all fixed services) rather than for unbundled local calls is a condition of demand or consumer preference (demand for a single bill for example) or a result of the existing constraints within the market for local call services. These constraints may include pricing by Telstra that involves reselling bundled local calls below the current access cost to other competitors.

Imputation testing carried out by the ACCC shows that competitors reselling only wholesale line rental and the local carriage rental are not able to make a profit.[89] Consequently, the ACCC's most recent competitive safeguard report (2003-04) indicates:

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87 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 62.

88 ibid., pp. 62-63.

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

> … a local telecommunications only entry strategy is not a viable option and resellers bundle local calls with other services, usually national long-distance, international (together with long-distance services) and fixed-to-mobile services (FTM).[90]

While a local-only strategy is not a viable competitive option, a carrier providing local calls with other fixed line services (including fixed to mobile, national and long-distance calls) may be able to earn a positive margin. The ACCC has therefore concluded that to be a prospective competitor to Telstra it is necessary to provide a full service.[91] All the companies currently operating in the local telephony market have taken this option. Therefore, another interpretation of the service being supplied could look to a market for fixed line calls. However, this bundling of services may be more the result of Telstra's market power than of complementarity or any economies of scope.

The current regime also provides three additional ways to compete in the combined national long distance, international and FTM market:

- a competitor may enter as a preselect provider, supplying long-distance and fixed to mobile services to a consumer who buys line rental and local calls from another provider
- a company may enter as an override competitor, offering long-distance, international and FTM calls to consumers who are willing to dial an override code
- a company may compete through calling cards.

While these services display substantial margins they are niche options only due to their specialised application, their level of inconvenience and because the pre-select option effectively involves higher prices in the local call market given current bundling practices. If a consumer chooses not to purchase a bundle of local and long distance calls from Telstra, the consumer will be charged a higher price for line rental and local call services, and will not be eligible for Telstra's 'reward options'. The increase in local prices and loss of rewards is the penalty to the customer for preselecting another competitor, and the preselect competitor must compensate the customer for this loss.

The niche market nature of these products is indicated by ACA figures that indicate that 75 per cent of residential consumers and 76 per cent of small business consumers currently buy all fixed–line services from a single supplier.[92]

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90 ACCC, *Telecommunications competitive safeguards for 2003-04,* March 2005, p13.

91 ibid., p. 14.

92 ACA, *Consumer satisfaction survey 2004, Special report No.14,* August 2004, Figure 11.

While there is considerable diversity within submissions, Telstra alone supports a downstream product/service market definition that encompasses the cluster market for line rental, local calls, national and international long distance calls and fixed to mobile calls.

Telstra's arguments are based upon what it sees as the observable retail market outcomes in terms of the predominance of bundled service offerings. From the demand perspective it satisfies customer's demand for one bill and from the supply perspective, bundling allows economies of scope to be achieved. In contrast, both AAPT and Optus argue that the observed outcomes are very much a result of Telstra's market power and the nature of the regulation, rather than market-derived outcomes emanating from demand or supply factors.

The relative use of the different services is shown in the following table using 2003-2004 RAF numbers. The table indicates that of all the fixed-line calls made in Australia in 2003-2004, 67 per cent were local calls.

Fixed call usage in Australia: 2003-2004

Retail Service	No of connected calls	No. of call minutes	Average minutes per call	Call type as a proportion of total calls	Call minutes as a proportion of total minutes
Local calls	**[c-i-c]**	**[c-i-c]**	**[c-i-c]**	67%	87%
Domestic Long Distance	**[c-i-c]**	**[c-i-c]**	**[c-i-c]**	14%	8%
International	**[c-i-c]**	**[c-i-c]**	**[c-i-c]**	1%	1%
Fixed to Mobile	**[c-i-c]**	**[c-i-c]**	**[c-i-c]**	18%	4%

Source: RAF reports, 2003-04.

It is clear from the above table that local calls dominate the usage of the network, both in terms of connected calls and number of call minutes. Unlike long distance and fixed to mobile calls, local calls are not priced on a timed basis. A comparison of the average length of calls using the above data suggests that local calls are services of a different nature to the other categories.

The ACCC has previously argued that local calls are "communicable products", and considers that the line rental product can be similarly described.[93] A communicable product is described as a product that has a significant profile with consumers, and in a consumer's mind is indicative of a retailer's general price competitiveness (products such as bread and milk are good examples). They are products that are purchased frequently and in high volumes. It has been argued that the significance of communicable products is that consumers tend to remember their prices and use the products to evaluate the comparative prices of different retailers.

Telstra claims that total expenditure on voice services is not dominated by the purchase of any one service. It is not substantiated by any evidence in the Telstra submission, however, the following table details the trend in proportion of PSTN voice expenditures reported through the RAF.

Proportions of total PSTN voice expenditure – 2001-02 to 2003-04

Service	2001-02	2002-03	2003-04
End-user access	30.4%	33.1%	35.7%
Local calls	22.0%	19.8%	18.4%
Domestic long distance calls	19.7%	18.7%	17.9%
International calls	6.5%	5.8%	4.9%
Fixed-to-mobile calls	21.4%	22.6%	23.1%

Source: ACCC, *Telecommunications Market Indicator Report*, June 2005, p. 10.

Further, the following table details the latest half-year revenue results for Telstra's PSTN services

Telstra's PSTN revenues for the half year ended 31 December 2005

Retail market service	Revenue ($ million)	Percentage of total
Line rental – retail - wholesale	1,309 349	34% 9%
Local call revenue	553	14%
PSTN value added services	123	3%
National long distance revenue	471	12%

93 ACCC, *Assessment of Telstra's undertakings for PSTN, ULLS and LCS, Final decision, December 2004*, p49. This concept was used in an ACCC case against Australian Safeway Stores. For discussion of this case and the concept see J Carmichael: Tip Top Result Goes Stale ACCC v Australian Safeway Stores Pty Ltd (No2), Deakin Law Review, 2002, 19, pp. 1-17

Fixed to mobile revenue	761	20%
International direct revenue	106	3%
Fixed interconnection	146	4%
Total PSTN revenue	3,818	

Source: Telstra Corporation Limited, *Half-year report for the half year ended 31 December 2005*, p. 11.

The above tables demonstrate that line rental is increasingly becoming the dominant expenditure item. For calling products, expenditure on local calls is only exceeded by that on fixed to mobile calls, however as noted above the number and minutes of local calls significantly outstrips fixed to mobile calls. Accordingly, given the communicable product status of both line rental and local calls, their shares of total telecommunications expenditure and the intensive use of local calls both in terms of minutes and numbers, it is reasonable to conclude that these services are clearly the most important to consumers. Thus, while there may be consumer preference for an offering which includes all fixed calls, the prices of local calls and line rental appear to be a determinative factor in the competitiveness of any bundled offering.

Bundling generally refers to the situation where two or more products or services are sold as a single package. The price of the package is usually at a discount to that of acquiring given amounts of a product separately. The residential consumer is likely to receive only one bill for all the services provided in bundles.[94] ABN-AMRO has commented that rather than full service bundles, Telstra has in the past offered packages. Packaging occurs where a customer is offered a discount for taking two or more services.[95] Packaging is likely to be less effective than full service bundling in capturing economies of scope and may not always mean a single bill.

Bundling can be evidence of economies of scope in supply especially as fixed line services use essentially comparable infrastructure. Telstra argues that bundling enables firms to defray customer specific fixed costs over a large number of services – indicating a supply side cluster. However, this does not adequately reflect the options currently available in the Australian market and the specific bundling (packaging) strategies that have been used by Telstra.

Access prices are determined using Telstra's unbundled local call price, which is significantly higher than its packaged/bundled offering. For competitors entering the market, bundled plans are the only viable option because it is necessary to provide discounts on either local services or long distance calls as part of a package to offset the competitive disadvantage which may arise from higher prices (in comparison to

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[94] ACCC, *Bundling in Telecommunications Markets*, August 2003. This information paper outlines the approach the ACCC is likely to follow when assessing specific bundling conduct in the telecommunications industry.

[95] ABN AMRO Equities Australia Limited, *Telstra Corporation*, 7 July 2005.

Telstra) for local services. Telstra's strategy therefore dictates the nature of the competitive response, and in this context the packages offered by competitors are not proof of the relative importance of economies of scope. Rather it is evidence of the limited options available to competitors and their need to provide a specific package response as part of any market entry strategy.

6.2.4.2 ACCC draft view

In identifying the scope of the relevant downstream market/s, Part XIC of the Act does not require the ACCC to take a definitive or determinative stance on market definition as may be the case in a Part IV or Part XIB matter.[96] The Federal Court also endorsed this approach in its decision to uphold the validity of certain broadcasting access declarations by the ACCC.[97]

Accordingly, the ACCC does not consider that in the context of this declaration review it is required to determine the precise boundaries of the downstream market. At their narrowest, the relevant downstream markets could be defined as the retail local call market and the retail line rental market. Alternatively, the relevant downstream market definition could be expanded to include other fixed calling products including fixed to mobile, national and long-distance calls. Again, the market/s should be seen as national but with the continued exemption of the relevant CBD areas.

The ACCC acknowledges that the majority of fixed voice services are generally sourced by consumers from a single supplier, on a bundled basis. However, all retail market voice offerings will generally include, at a minimum, line rental and local calls.

Accordingly, as the purpose of market definition with respect to the declaration of the eligible services is to assess whether or not competition will be promoted, the ACCC does not believe it is required to form a precise view as to the boundaries of the downstream retail voice market as, at its narrowest there could be found to exist separate retail markets for line rental and local calls, or more widely a market for retail fixed voice services which necessarily includes both retail line rental and local call services.

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[96] ACCC, *Telecommunications services – Declaration provisions*, July 1999.

[97] Foxtel Management Pty Ltd v Australian Competition & Consumer Commission [2000] FCA 589.

7 Test for declaration – local call

7.1 Would declaration of the LCS continue to be in the LTIE?

Section 152AL of the TPA provides that the ACCC may declare an eligible service if it is satisfied that the making of the declaration will promote the LTIE of carriage services or services provided by means of carriage services. In turn, section 152AB of the TPA provides that, in determining whether declaration promotes the LTIE, regard must be had only to the extent to which declaration is likely to result in the achievement of the following objectives:

- promoting competition in markets for listed services
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users
- encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied.

In addition, where appropriate and where the ACCC considers it usefully facilitates its consideration of the matters under section 152AH(1) the ACCC has given consideration to the 'future with and without' test, expressed in the Sydney Airports case[98]. Applying this test requires the ACCC to contrast the outcome assuming the line rental service is declared against the outcome assuming the line rental service is not declared. The ACCC does not apply this test where it considers it does not helpfully assist it with determining the reasonableness of particular terms and conditions. The ACCC notes that while the 'future with and without' test can be applied explicitly, in most instances it is implicit in the ACCC's assessment.

The impact of declaration on each of the three subsidiary LTIE objectives is addressed in turn below.

7.2 Will declaration promote competition?

The concept of competition is of fundamental importance to the TPA. Competition may be inhibited where the structure of the market gives rise to market power. Market power may be drawn from the ownership of infrastructure required for providing

[98] *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

services in the downstream market. Without access to the services provided by infrastructure, a firm would not be able to operate in the downstream market.

The establishment of a right for third parties to negotiate access to certain services, on reasonable terms and conditions, can operate to constrain the use of market power, which could be derived from the control of these services. An access regime such as Part XIC, or Part IIIA of the TPA, attempts to change the structure of a market, to limit or reduce the sources of market power and consequent anti-competitive conduct, rather than directly regulating conduct which may flow from market power (which is the role of Part IV and Part XIB of the TPA).

7.2.1 Assessment of competitiveness

In this section the ACCC assesses the level of competition in the market for local call services. This analysis draws upon the market information set out in the previous section and the conclusions drawn by the ACCC in the recent *Telecommunications Competitive Safeguards for 2003-04* report.[99]

7.2.2 Defining competitiveness

While economic theory stresses the importance of perfect competition in providing efficient outcomes, a standard theory of 'effective competition' is more often applied in practice. The ACCC has made an attempt to highlight some of the characteristics of effective competition.[100] Effective competition is likely to be associated with one or more of the following characteristics. That is:

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

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[99] ACCC, *Telecommunications competitive safeguards for 2003-04*, March 2005.

[100] Ibid., p. 8.

While a more detailed discussion of the relationship between access/service competition and facilities-based competition occurs in section 5, here it is worth noting the ACCC's past comment that:

> ..part of the analysis of effective competition must centre on whether there are the appropriate conditions, both competitive and regulatory, to foster dynamic improvements and not just static competition at the current level.[101]

The sustainability of competition must also be assessed. Of particular importance, a market may be said to be sustainably competitive if the benefits that have already accrued would not be lost with the removal of regulation.

Several partial indicators can be used to assess the level of effective and sustainable competition. These indicators include:

- market share and number of competitors
- pricing conduct-significant price decreases are usually an indicator of increased competition although small price increases or decreases can be indicative of a range factors independent of the level of competition in the market
- the existence of barriers to entry such as switching costs, sunk costs and increasing returns to scale.

7.2.3 Characteristics of the LCS market

The critical characteristics of the local call and line rental market have been highlighted in the previous section:

- line rental is a prerequisite for consuming all fixed-line products and also ADSL broadband. Telstra's copper customer access network is essentially a natural monopoly and the source of Telstra's dominance
- while there are three competitive models for local calls the vast majority rely on telephony services provided using Telstra's CAN
- Telstra and Optus are the only full service carriers in all market segments. Other carriage service providers providing local calls and line rental include AAPT, Primus, ACN, Southern Phone Company, SP Telemedia, Macquarie Telecom, etc. The following table shows that while there have been some reductions in Telstra's share of revenue for line rental and local calls from 2001-02, this reduction amounts to a slight adjustment only and the increased revenue share has been taken up by Optus rather than the others in the telecommunications

[101] Ibid., p. 9.

industry. Telstra still has dominance in terms of revenue share. Only 7.2 per cent of line rental revenue and 9.5 per cent of local call revenue was earned by competitors other than Telstra and Optus in 2003-04. Further, these figures are aggregated and therefore include revenue earned in regions of the market currently considered to be competitive and therefore exempt from declaration, and thus are likely to understate Telstra's market shares for the remainder of the national market

Retail revenue share by carrier, 2001-02 to 2003-04

		Telstra	Optus	Other
Line rental		%	%	%
	2001-02	89.6		10.4
	2002-03	86.8	6.0	7.2
	2003-04	82.1	10.6	7.2
Local calls				
	2001-02	78.2	10.2	11.5
	2002-03	77.0	14.4	8.7
	2003-04	75.4	15.0	9.5

Source: ACCC, Telecommunications market indicator report, June 2005, p.11.

- while there is significant retail competition in the CBD's (Sydney, Melbourne, Brisbane, Adelaide and Perth are exempt from the declaration), 99 per cent of the wholesale market is supplied by Telstra **[c-i-c per cent]** and Optus **[c-i-c per cent]**, with Optus' current and potential future supply geographically constrained to areas served by its HFC. In provincial centres while alternative carriers offer the prospects of alternative sources of supply, Telstra currently provides **[c-i-c per cent]** of connections. In rural and remote areas, Telstra is currently the only carrier that operates in all states and provides local access networks that are not satellite, providing **[c-i-c per cent]** of connections

- the LCS has a range of potential substitutes—take up of the ULL, shift from fixed to mobile, use of VoIP. However, for the reasons outlined in the previous section it would be difficult to consider that any of these potential substitutes are likely to be effective substitutes for the LCS within the next few years.

7.2.4 Responses to the discussion paper

AAPT

AAPT claims that the market for local telephony is not competitive anywhere. AAPT argues that there is a national market for telephony services, but that:

> The existence in one geographic location of competitive infrastructure does not guarantee access to that infrastructure to an alternative service provider.[102]

AAPT suggests that without the ubiquity of coverage that Telstra has, competitors are not able to meet the needs of consumers.

Australian Communications Network Pty Ltd (ACN)

ACN believes that the LCS declaration has not led to a great deal of facilities-based competition, but has provided consumer benefit through increased retail competition. ACN argues that even where carriage service providers progress from LCS to more facilities-based alternatives, in fact:

> The only realistic competitive alternatives to LCS are not true facilities-based competition but merely other types of access-based competition.[103]

Although ACN believes that access-based competition has provided consumer benefit during the period of the LCS declaration, it suggests that this has begun to falter. ACN believes that Telstra has been able to exploit deficiencies in the declaration related to bundling of services and functional equivalence.

Competitive Carriers' Coalition

The CCC states:

> There are no substitutes presently available for LCS. The available alternatives are limited because they rely on access platforms that are themselves limited.[104]

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[102] AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 12.

[103] Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 2.

[104] Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 4.

In relation to line rental, the CCC believes that there are no universal substitutes and as such it is an enduring bottleneck.

Optus

Optus does not believe that the LCS has led to a great deal of ULLS-based competition thus far, but considers that recent ULLS price reductions give cause for greater optimism:

> With the improvement of the ULLS business case, we could reasonably expect competition in the local calling services market to emerge, reducing the need for costly LCS access regulation.[105]

Optus further states:

> Optus believes that the provision of local calling services in metropolitan areas could only be removed from regulatory oversight when sufficient competition exists in the wholesale provision of local call resale services (via DSLAM rollout).[106]

Optus believes that the ACCC should determine a threshold level at which regulation in a given band should be rolled back:

> Optus recommends the Commission adopt an 80% target – that is, roll back regulation when 80% of exchanges in metropolitan areas have a competitor's DSLAM installed and in service.[107]

Southern Phone Company (SPC)

SPC believes that competition in regional areas is not sufficient to roll back regulation:

> …the lack of economies of scale make it extremely unlikely that a competitive infrastructure can be developed in regional Australia to deliver local call services.[108]

Further, SPC states:

> Southern Phone believes any declaration of LCS must recognise the circumstances of regional Australia and allow a continued cross subsidy in service provision between regional and metro areas.[109]

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[105] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 5.

[106] ibid., p. 7.

[107] ibid., p. 8.

[108] Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

[109] ibid.

Telstra

Telstra states:

> Telstra believes that there is substantial access-based competition in the downstream fixed telephony services market and the benefits to consumers of this competition will be retained absent the declaration of LCS. A decision by the Commission not to extend its declaration of LCS will, on the other hand, promote competition by giving service providers the appropriate incentives to use and extend alternative infrastructure.[110]

With regard to the upstream market, Telstra submits:

> …that the alternative infrastructure and declared services such as ULLS and LSS, provides sufficient competition in the local service market that will be sustained absent LCS declaration.[111]

7.2.5 Pricing conduct

Retail price controls have meant that RMRC has been used to ensure neutrality between access seekers and Telstra at the retail level. Access prices are determined using Telstra's unbundled local call price. However, the unbundled local call price is significantly higher than its packaged/bundled offering. For competitors entering the market, bundled plans are the only viable option because it is necessary to provide discounts on either local services or long distance calls as part of a package to offset the competitive disadvantage which may arise from higher prices (in comparison to Telstra) for local services. If a full service bundle is provided by competitors, Telstra imputation tests indicate that there is potentially scope for competitive entry. Even so Telstra can price squeeze its competitors by increasing its unbundled local call prices relative to its bundled local call prices without any corresponding increases in the prices of other services in the bundle.

Price competition in the corporate market has been much more robust and local call prices have declined significantly over the 2002-04 period.

7.2.6 Barriers to entry

Status quo bias can act as a barrier to entry. When combined with actual switching costs (contract lock-in etc) Telstra has considerable advantage as the incumbent provider of telecommunications. Potential competitors have to provide an inducement, such as lower prices, to overcome this bias. This implies that there is less profit to be made as a total service provider than imputation testing is capable of indicating.

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110 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 9.

111 ibid., p. 10.

Entry into the market may also involve significant risks. To achieve scale economies a firm may need to sell below costs while waiting for market share to push average costs down. This may not be achievable. Sunk costs have also to be considered. To provide the full bundle, contracts would need to be made at minimum with Telstra, Optus, Vodafone, an intra-capital and inter-regional transmission provider and for an international termination service.

Competitors in this market have also to rely upon Telstra to provide services as well as maintenance and churn. In such circumstance economic theory suggests that the incumbent will face a strong incentive to provide lower quality or higher cost services.

The ACCC has concluded that while when assessed individually these barriers may not seem to be insurmountable, taken together they form a significant barrier to entry.

7.2.7 Overall assessment of competition

Other than the market for corporate communications the ACCC is not convinced that the downstream retail voice market is effectively competitive. The market is highly skewed and only Telstra and Optus would appear to be well established in the market. Telstra is the main supplier of wholesale local telephony services, with a market share of around **[c-i-c per cent]**.[112] Service providers re-supplying Telstra's services are the primary source of retail market competition, although as outlined above there is some geographically limited competition from facilities-based operators such as Optus.

The declaration of the unconditioned local loop service was designed to promote competition in the local telephony services market, with service providers supplying end-users with telephony services either as part of a package with high bandwidth carriage services or independently. Such competition has, however, taken some time to emerge with developments ongoing at this stage.

As an alternative to using the unconditioned local loop service to supply local calls, access seekers may be able to use the local PSTN originating and terminating services. The extent to which they will be able to do so is currently unclear in the absence of a pre-selection determination covering local calls. As such a determination is not currently in place, and further given the level of uncertainty regarding the way in which local calls will be routed and provided following network modernisation and increased usage of the ULLS, the ACCC does not consider that it is required to come to a firm viewpoint on this issue in the draft decision.

Until the unconditioned local loop service is more widely used by service providers and/or the local PSTN originating and terminating services can be used to supply local

[112] ACCC, *Telecommunications Infrastructure in Australia 2004,* June 2005, p. 17.

calls, service providers re-supplying local telephony services to end-users are likely to provide the main form of local telephony competition.

The ability of these service providers to compete effectively in the local telephony market through re-supplying local telephony services is largely influenced by the terms and conditions on which local carriage services are supplied to them. The charges paid by service providers to Telstra represent the overwhelming majority of the revenue received by service providers from their customers for those services. The wholesale supply of these services to service providers is not subject to effective competition, as outlined in the previous section.

Continued declaration of the local carriage service would therefore constrain the ability of suppliers of these services to influence competition in the downstream retail market. However, without declaration of this service, it is likely that, given these services are supplied in a wholesale market which is not currently subject to effective competition, access seekers may be either unable to procure access to the LCS, or access on reasonable terms and conditions. That is, in the absence of declaration of the LCS, it is unlikely that competition in the downstream market will be sustainable, and therefore cannot be held to be effective in the absence of declaration at this stage. As a result, the ACCC is firmly of the view that continued declaration of the LCS is likely to promote competition in the downstream market for retail voice services.

In determining the extent to which declaration is likely to promote competition, the ACCC must also have regard to the extent to which it will remove obstacles to end-users gaining access to carriage services or services provided by means of carriage services (subs. 152AB(4)).

In this regard, fixed telephony services already have a high level of penetration in Australia (i.e. around 50 per cent of the population); continued declaration is not expected to increase the penetration of telephony services. It can, however, provide end-users with additional choices in terms of service provider, increased competition on the retail service dimensions, and, depending on the service provider's costs, lead to lower priced local calls for end-users. These benefits are likely to continue to be enjoyed on an ongoing basis by end-users who are unlikely to be served by alternative customer access infrastructure in the foreseeable future (i.e., the majority of residential end-users and business end-users except for large corporate and government users).

It is important to keep in mind that this conclusion is made in the context of a particular market definition, specifically one bounded by a specified time period limited to two years. After this period, the ACCC considers that a sufficient level of uncertainty regarding future developments of wholesale substitutes to the LCS may be resolved. This is likely to necessitate a re-evaluation of whether the continued declaration of the LCS is likely to promote competition, and where substitutes are found to be sufficiently effective, to forbear from continued regulation of the service.

Consideration of the pricing approach the ACCC would be likely to adopt in the event that it was required to determine prices for the LCS is discussed in section 9 of this report.

7.3 Will declaration achieve any-to-any connectivity?

As noted above, the concept of any-to-any connectivity is not always relevant in the declaration context. With respect to the local carriage service, it appears that declaration of this service will have no impact on the objective of achieving any-to-any connectivity.

7.4 Will declaration encourage economically efficient use of, and investment in, infrastructure?

As discussed in section 3 of this report, when deciding whether declaration of a service will be in the LTIE, the ACCC is required to consider whether declaration would be likely to encourage:

- economically efficient use of infrastructure, and
- economically efficient investment in:
  - the infrastructure by which listed services are supplied
  - any other infrastructure by which listed services are, or are likely to become, capable of being supplied.

In determining the extent to which a particular thing is likely to encourage the efficient investment in other infrastructure, the ACCC must have regard to the risks involved in making the investment.

In considering these questions, the ACCC is mindful that such consideration must be made in an environment where the local carriage service is already declared. Hence, the ACCC addresses these issues from the perspective of considering the likely consequences ‘with’ continued or varied declaration as opposed to those that could be reasonably expected ‘without’ declaration.

The ACCC’s consideration of each of these decisions on economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are provided is outlined in turn below.

7.4.1 Responses to the discussion paper

Given the natural monopoly characteristics of Telstra's local loop, Optus believes that the ULLS service offers the best prospect of promoting competition in the LCS services market. The ULLS offers a way of enabling competition by allowing customers to choose their access services over the copper—thereby providing contestability to the local loop infrastructure. In this context, Optus argues that:

> … the ULLS service specifically targets the market failure that has previously lessened competition in both the wholesale and retail markets for local calling services.[113]

In its submission, AAPT stated that it is clearly inefficient to duplicate telecommunications facilities where unused capacity exists as this has the potential of promoting irrational competition. That is, an environment where service providers compete by pricing at the short-run marginal cost of the service rather than the long-run marginal cost plus a proportion for common costs. AAPT considers that:

> Such pricing behaviour is unsustainable but creates the illusion of an effectively competitive market.[114]

The Competitive Carrier Coalition (CCC) submitted that competitors in the LCS services market are likely to adopt different investment strategies that reflect the market conditions in different geographical locations and customer segments. As such, the CCC believes that:

> … some competitors might not wish to invest beyond what is necessary to establish a pure reseller business… If a competitor can establish a position in the market as a pure reseller, they should be free to do so, and it should be acknowledged that this adds a useful element of competitive tension to a market, especially where facilities-based competition is nascent.[115]

In its submission Telstra's comments on investment focussed on the use of PSTN O/T to provide local calls. Telstra argues that the use of PSTN O/T to provide local calls is inconsistent with the efficient use of and investment in infrastructure. Additionally, Telstra considers that it is at odds with encouraging infrastructure-based competition. In support of this argument, Telstra stated that multi-basket preselection would need to be implemented by industry in order for local calls to be provided using the PSTN O/T and this would involve substantial costs, not only to Telstra but all carriers. Moreover, Telstra believes that:

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113 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 19.

114 AAPT, *Submission by AAPT Limited to the Australian Competition and Consumer Commission in response to 'Local Services Review 2005: An ACCC Discussion Paper, April 2005'*, June 2005, p. 7.

115 Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 3.

> … these costs cannot be justified, as there are no benefits to be gained from the provision of local calls via preselection that are not already achievable through LCS.
>
> Use of PSTN OTA for the carriage of local calls would introduce inefficient call handling and trunking by all carriers. Instead of local calls staying in Telstra's PSTN, these calls would be transmitted from Telstra's local access switch ("LAS") via Telstra's inter exchange network to the access seekers point of interconnect into the access seekers switch and then back from the access seekers switch to Telstra's PSTN to either the same or a different LAS.[116]

In addition, Telstra submitted that using PSTN O/T to supply local calls would shift significant volumes of traffic into the trunk layer of the PSTN, requiring Telstra to invest many millions of dollars to augment capacity on that part of its PSTN. Access seekers would incur additional costs as they would need to increase their interconnect capabilities—i.e., the transmission systems to their switches to the point of interconnect and add switchports on their switches. Notwithstanding these additional costs to industry, Telstra believes that:

> … making PSTN OTA available for the provision of local calls is likely to slow the move to ULLS rather than hasten it. PSTN OTA provides a lower cost access-based solution for access seekers in CBD and metropolitan areas and hence reduces the attractiveness to access seekers of moving LCS to ULLS. Rather, access seekers would be able to obtain at least part of the gains simply from moving to PSTN OTA for the provision of local calls.[117]

7.4.2 Impact on efficient use of infrastructure

As indicated in section 3, the ACCC considers that efficiency has three major components – allocative, productive and dynamic. In general, each of these forms of efficiency is enhanced when the prices of given services reflect the costs of providing these services. In more competitive markets, service providers have a greater incentive to lower prices in order to win market share. Accordingly, this incentive helps push prices towards costs, and thereby improves the efficient use of resources, and therefore infrastructure.

Where declaration is likely to promote competition in markets for carriage services or services provided by means of carriage services, the ACCC's competition analysis will generally help it to form a view about the impact of declaration on efficiency. For instance, where the ACCC finds that declaration can lead to greater competition in downstream markets by helping to ensure prices for the eligible service better reflect their efficient costs of provision, it is likely such declaration will also help promote efficiency in use of telecommunications services. By enabling greater competition in downstream markets, declaration would be expected to improve productive and dynamic efficiency in these markets by giving service providers the incentive to find

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116 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 34.

117 ibid, p. 35.

lower-cost means of producing goods and services in downstream markets, and by encouraging both access providers and access seekers to invest and innovate in ways that will ensure they produce goods and services of a chosen quality at the lowest possible cost in the future. Further, the ACCC would expect allocative efficiency to be improved as it would be more likely that over time the final prices paid for retail services by end-users will better reflect the efficient costs of provision of these services.

In the language of subsection 152AB(2)(e), declaration will be expected to result in the more efficient use of infrastructure used to supply the eligible service. Conversely, a decision not to declare would – on this reasoning – lead to less competition in downstream markets and a less efficient outcome.

The ACCC therefore considers that, in the absence of declaration, Telstra is unlikely to be constrained in the pricing of services in the downstream market. As a result, in the absence of declaration Telstra is less likely to face the correct incentives to price its services in ways which promote the efficient use of infrastructure. Conversely, declaration provides access seekers with access to the declared service on reasonable terms and conditions, and in doing so is likely to place competitive pressure on Telstra such that all parties will face the correct incentives to price their services in ways which reflect more efficient use of the underlying infrastructure. Accordingly, the ACCC is of the view that continued declaration, as opposed to its cessation, is more likely to promote the efficient use of infrastructure.

Finally, in considering the impact of declaration of a service on the efficient use of telecommunications infrastructure, the TPA also requires the ACCC to consider whether it is 'technically feasible' to supply and charge for the eligible service when determining whether declaration would encourage the efficient use of infrastructure. In this regard, the ACCC must particularly consider:

- whether supply is feasible in an engineering sense (i.e. having regard to the technology that is in use or available)
- the costs of supply and whether the costs are reasonable
- the effects, or likely effects, of supply on the operation or performance of telecommunications networks.

Given the local carriage service has been declared and provided since 1999, the ACCC believes it is technically feasible to provide a local carriage service.

7.4.3 Incentives for efficient investment in existing infrastructure

Issues relating to the impact of declaration on the maintenance, improvement and expansion decisions in respect of infrastructure used to supply the local carriage service were not specifically raised during this review.

The incentives for efficient investment in existing PSTN infrastructure are predominately driven by pricing and demand considerations. This investment could either be in existing PSTN infrastructure or in replacement network infrastructure, such as an IP based network.

The ACCC is of the view that, by enabling access, declaration provides competitive tension in the market such that it is reasonable to expect that incentives for efficient investment are likely to be promoted. Conversely, in the absence of declaration, competition is likely to place less pressure on the incumbent to invest efficiently. The ACCC is therefore of the view that continued declaration of the LCS is likely to promote incentives for efficient investment in existing infrastructure.

7.4.4 Incentives for efficient investment in new infrastructure

This aspect can be looked at from at least two perspectives. The incentives on Telstra to invest in new networks and the incentives on access seekers to invest in their own facilities or networks.

The supply of local call services using the LCS has enabled service providers to become familiar with the market and make more informed investment decisions. In addition, it has facilitated service providers to establish a customer base and steady cash flow before embarking on infrastructure investment. These factors reduce the investment risks which, in the context of an industry where investment is characterised by sunk costs and economies of scale, serves to reduce the barriers to market entry. In this way declaration is likely to have had a positive effect on investment by access seekers. In the absence of declaration, the ability of access seekers to acquire the LCS, or to acquire it on reasonable terms and conditions, would be inhibited and it is reasonable to conclude that access seekers incentives for efficient investment in new infrastructure would be distorted.

In relation to Telstra, the issue therefore that needs to be addressed is whether continued declaration of local carriage services is likely to impede Telstra's investment in PSTN replacement infrastructure. In other words, if the LCS declaration is continued, will there be sufficient incentives for Telstra to invest in new technologies—aimed at providing new and improved local carriage services at presumably lower cost to end-users.

In this regard, the ACCC notes that the LCS has been a declared service for an extended period of time. There is no information to suggest that Telstra has been unwilling to invest in infrastructure as a result of this declaration. Further, the ACCC notes that Telstra has recently announced plans to significantly modernise its core network, and considers that there is no evidence to suggest that the continued declaration of this service is likely to negatively impact on Telstra's incentives to undertake investment in this, or any other new infrastructure.

7.4.5 ACCC's preliminary view

The ability of service providers to compete effectively in the local telephony market through re-supplying local telephony services is largely influenced by the terms and conditions on which local call services are supplied to them. The ACCC considers that continued declaration of the local carriage service would constrain the ability of dominant suppliers to unduly influence competition in the local telephony services market. This is likely to promote competition in that market and in the long distance telephony services market where local telephony services are bundled with long distance calls for customers who prefer to acquire those services from a single provider and thereby promote the interests of end-users.

In the ACCC's view, continued declaration of the local carriage service is likely to encourage efficient investment in infrastructure used to supply local telephony (and possibly other) services. It will continue to facilitate market entry and enable service providers to obtain information about demand characteristics and the likely responses of competitors, thus reducing the risks associated with infrastructure deployment. This will enable service providers to make efficient decisions about when to deploy competing facilities. Similarly, Telstra's incentives to efficiently invest in replacement technologies to deliver voice services will not be unduly affected by the continued declaration of the LCS.

8 Test for declaration – line rental service

8.1 Would declaration of the line rental service be in the LTIE?

As noted above, the ACCC may declare an eligible service if it is satisfied that the declaration is likely to result in the achievement of the following objectives:

- promoting competition in markets for listed services
- achieving any-to-any connectivity in relation to carriage services that involve communication between end-users
- encouraging the economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are supplied

In addition, where appropriate and where the ACCC considers it usefully facilitates its consideration of the matters under section 152AH(1) the ACCC has given consideration to the 'future with and without' test, expressed in the Sydney Airports case[118]. Applying this test requires the ACCC to contrast the outcome assuming the line rental service is declared against the outcome assuming the line rental service is not declared. The ACCC does not apply this test where it considers it does not helpfully assist it with determining the reasonableness of particular terms and conditions. The ACCC notes that while the 'future with and without' test can be applied explicitly, in most instances it is implicit in the ACCC's assessment.

The following is the ACCC's assessment of the impact of declaring the line rental service on the above objectives.

8.2 Will declaration promote competition?

The line rental service is an essential component in provision of retail telephony services such as local, long distance and international calls. These, and other, basic telephony services cannot be provided without the line rental service, which allows for access to the public switched telephone network.

While not currently declared, the line rental service is at present provided and priced through the supply of the local carriage service, and thus is effectively declared on a de facto basis. As indicated in section 6.2.2.1, the ACCC believes that the line rental

[118] *Sydney Airports Corporation Ltd* (2000) 156 FLR 10.

service should be treated as a separate eligible service. It is the ACCC's view that the line rental service is a pre-requisite for the competition in provision of basic telephony services provided using local carriage service, and PSTN originating and terminating access. Further the line rental service is almost always bundled with the provision of local calls, and generally with long distance telephony. As such, reasoning regarding promotion of competition identified when considering declaration of the local carriage service (above) is also relevant here.

The ACCC therefore considers that the above analysis with regards to the promotion of competition with respect to the declaration of LCS as set out in section 7.2 usefully informs the ACCC's analysis with respect to the line rental service. That is, the ACCC's market analysis leads to the conclusion that at this stage the wholesale market for the provision of line rental is not effectively competitive. Accordingly, the observed level of retail competition is heavily reliant upon resale of Telstra's line rental service. In the absence of declaration of this service, it is relatively more likely that access seekers may be either unable to procure access to wholesale line rental, or access on reasonable terms and conditions to the detriment of competition. That is, in the absence of declaration of a wholesale line rental service, it is unlikely that competition in the downstream market will be sustainable, and therefore cannot be held to be effective in the absence of declaration at this stage.

Telstra states:

> … Telstra submits that a basic access service should not be declared. Telstra has never in the past refused to supply basic access on reasonable terms and conditions.[119]

The ACCC does not consider that Telstra's arguments are credible. The ACCC has consistently held the view that where the market for the supply of an eligible service is not effectively competitive, then declaration (or continued declaration) of the service is likely to lead to improved terms and conditions of access relative to what would otherwise be the case. The ACCC's market analysis for the wholesale line rental service concluded that this market is currently not subject to effective competition. Accordingly, the ACCC considers that there is no reasonable basis to conclude that Telstra is either likely to continue to provide the service, or to continue to provide it on reasonable terms and conditions, in the absence of declaration.

A secondary consideration with regards to the promotion of competition is the extent to which access seekers' ability to procure a line rental service on reasonable terms and conditions is likely to promote competition in broadband markets with respect to xDSL services. That is, as outlined earlier, under current conditions consumers are required to purchase line rental in order to procure xDSL services on Telstra's network. Where it is part of either Telstra's or access seekers' competitive strategies to bundle fixed

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[119] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 15.

voice services with xDSL, any inhibition of access seekers' ability to purchase a wholesale line rental service, or to purchase on reasonable terms and conditions, is likely to inhibit competition. Accordingly, to the extent that part of the downstream retail market is characterised by a bundled product offering including xDSL services, competition in the market for retail broadband services is likely to be further promoted by the declaration of a wholesale line rental service.

As a result, the ACCC is firmly of the view that declaration of a wholesale line rental service is likely to promote competition in the downstream market for retail voice services. Declaration of the line rental service will promote competition in retail markets for telephony service, and may further promote competition for other retail services which require provision of line rental (e.g. provision of ADSL) as part of a bundle.

8.3 Will declaration achieve any-to-any connectivity?

As with the local carriage service, it appears that a declaration of the line rental service will have no impact on the objective of achieving any-to-any connectivity.

8.4 Will declaration encourage economically efficient use of, and investment in infrastructure?

In determining whether a declaration of the line rental service is encouraging the economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are supplied, the ACCC is mindful that such consideration must recognise that while the line rental service is currently not declared, the pricing of the local carriage service has always included the pricing of the line rental service (both directly and indirectly).

The ACCC also believes that the 'future with or without' test is very useful in this analysis.

8.4.1 Impact on efficient use of infrastructure

Telstra has claimed that without the declared line rental service, it would continue to provide the service on reasonable terms and conditions.[120] However, without declaration, Telstra has an incentive to price the service above competitive levels and/or restrict the supply of the service. Therefore, without the declared line rental service, the infrastructure required for the provision of the service would be likely to be underutilised, and prices for services would be likely to be inefficiently high. An

[120] ibid.

inability to access the declared service on reasonable terms and conditions would therefore likely have the effect, as noted above, of reducing competition. By enabling greater competition in downstream markets, declaration would be expected to improve productive and dynamic efficiency in these markets by giving service providers the incentive to find lower-cost means of producing goods and services in downstream markets, and by encouraging both access providers and access seekers to invest and innovate in ways that will ensure they produce goods and services of a chosen quality at the lowest possible cost in the future. Further, the ACCC would expect allocative efficiency to be improved as it would be more likely that over time the final prices paid for retail services by end-users will better reflect the efficient costs of provision of these services.

8.4.2 Incentives for efficient investment in existing infrastructure

Issues relating to the impact of declaration on the maintenance, improvement and expansion decisions in respect of infrastructure used to supply the local carriage service were not specifically raised during this review.

The incentives for efficient investment in existing PSTN infrastructure are predominately driven by pricing and demand considerations. This investment could either be in existing PSTN infrastructure or in replacement network infrastructure, such as an IP based network.

The ACCC is of the view that, by enabling access, declaration provides competitive tension in the market such that it is reasonable to expect that incentives for efficient investment are likely to be promoted. Conversely, in the absence of declaration, competition is likely to place less pressure on the incumbent to invest efficiently. The ACCC is therefore of the view that continued declaration of the LCS is likely to promote incentives for efficient investment in existing infrastructure.

8.4.3 Incentives for efficient investment in new infrastructure

This aspect can be looked at from at least two perspectives. The incentives on Telstra to invest in new networks and the incentives on access seekers to invest in their own facilities or networks.

The supply of line rental services in conjunction with the LCS declaration has enabled service providers to become familiar with the market and make more informed investment decisions. In addition, it has facilitated service providers to establish a customer base and steady cash flow before embarking on infrastructure investment. These factors reduce the investment risks which, in the context of an industry where investment is characterised by sunk costs and economies of scale, serves to reduce the barriers to market entry. In this way declaration is likely to have had a positive effect on investment by access seekers. In the absence of declaration, the ability of access seekers to acquire a wholesale line rental service, or to acquire it on reasonable terms and conditions, would be inhibited and it is reasonable to conclude that access seekers incentives for efficient investment in new infrastructure would be distorted.

In relation to Telstra, the issue therefore that needs to be addressed is whether continued declaration of line rental services is likely to impede Telstra's investment in PSTN replacement infrastructure. In other words, if a wholesale line rental service is declared, will there be sufficient incentives for Telstra to invest in new technologies—aimed at providing new and improved line rental services at presumably lower cost to end-users.

In this regard, the ACCC notes that line rental has effectively been a declared service for an extended period of time. There is no information to suggest that Telstra has been unwilling to invest in infrastructure as a result. Further, the ACCC notes that Telstra has recently announced plans to significantly modernise its core network, and considers that there is no evidence to suggest that the continued declaration of this service is likely to negatively impact on Telstra's incentives to undertake investment in this, or any other new infrastructure.

In addition, any likely increase in wholesale-based and facilities-based competition as a result of this declaration will provide further incentives for either Telstra and other providers to innovate and invest in alternate technologies (such as wireless), and next generation networks (such as fibre to the node) so as to improve the quality and lower the costs of providing wholesale line rental services over time.

Without the declared local carriage service, and line rental service, the incentives for investment in new and innovative infrastructure would greatly diminish, as higher barriers to entry arising from high investment risk and lack of scale economies would exist. Telstra is relatively more likely to remain dominant in the wholesale provision of the declared service, and relatively less likely to face competitive pressure to invest and innovate.

8.5 ACCC's preliminary view

The ACCC's preliminary view is that a declaration of the line rental service would result in promotion of competition in markets for listed services, and will encourage the economically efficient use of, and economically efficient investment in, the infrastructure by which telecommunications services are supplied. Therefore the ACCC's preliminary view is that the line rental service should be declared.

9 Pricing principles for local services

The prices charged for declared services have a significant impact on the promotion of the LTIE. The ACCC is required by s.152AQA of the TPA to determine, in writing, principles relating to the price of access to declared services. The determination may also contain price-related terms and conditions relating to access to the declared service. The ACCC must make such a determination at the same time as, or as soon as practicable after the ACCC declares a service, and further that the ACCC must publish a draft of the determination and invite submissions on the draft prior to any final determination.

The ACCC sees a benefit in signalling at the draft decision stage of a declaration inquiry its thinking on what should be the appropriate principles used to determine a price for the eligible service, were it to be declared. The principles specified in such a determination are indicative of the approach that the ACCC would likely take should it be required to arbitrate a dispute relating to the price of access. Although a party may still argue against the application of those principles to its case, determining pricing principles will guide commercial negotiation of access by providing greater certainty as to the ACCC's views on reasonable access prices.[121] Any draft determination need not necessarily exercise the ACCC's ability to determine price-related terms and conditions of access to the declared services.

This section presents the ACCC's draft view on appropriate pricing principles for the LCS and wholesale line rental services (together the 'declared services') after it has analysed and given due consideration to the submissions of interested parties in response to its Discussion Paper released in April 2005. In this regard, this section constitutes the ACCC's draft determination of principles relating to the price of access to the declared services in accordance with the requirements of section 152AQA(4) of the TPA. In order to elucidate upon how the ACCC approached the development of these pricing principles, this section considers:

- the legislative criteria the ACCC is required to consider when determining or assessing the terms and conditions of access to declared services
- submissions from interested parties
- the relativity between costs and retail prices

[121] See: Commonwealth, *Trade Practices Amendment (Telecommunications) Bill 2001*, pp. 10, 18.

- the relative merits of alternative forms of pricing principles considered during this inquiry under each of the statutory criteria
- general implementation issues related to the ACCC's draft preferred pricing principle
- the ACCC's draft view on the form of pricing principle most appropriate for the declared services.

For the avoidance of any confusion, s.152AQA(2) of the TPA outlines that a pricing principle determination made by the ACCC may also contain price-related terms and conditions relating to access to the declared service. Whilst this section outlines the general approach the ACCC believes would be appropriate for pricing the declared services, the ACCC has not at this stage chosen to determine the price-related terms and conditions relating to access to the declared services.

9.1 Legislative criteria

An important consideration in ensuring that access to declared services would promote the LTIE is whether the terms and conditions of access (including the price or a method for ascertaining the price) are reasonable. This is because the mere provision of access by an access provider may not be sufficient to promote the LTIE. The terms and conditions under which access is provided, particularly the price, are therefore also important in determining the degree to which the LTIE is promoted by declaration. The ACCC's role in assessing terms and conditions generally revolves around assessing undertakings and arbitrating disputes. In these circumstances, the TPA requires that the terms and conditions of access are reasonable.[122] In determining whether terms and conditions are reasonable, regard must be had to the following matters as set out in s.152AB and s.152AH of the TPA:

- whether the terms and conditions promote the LTIE of carriage services or of services supplied by means of carriage services, which in turn are achieved by:
    - promoting competition in markets for telecommunications services
    - achieving any-to-any connectivity in relation to carriage services that involve communication between end-users and

[122] The ACCC must also ensure that the terms and conditions in undertakings and any arbitration determination are consistent with any Ministerial pricing determination in place. See s. 152CH of the TPA.

- encouraging the economically efficient use of, and the economically efficient investment in, the infrastructure by which telecommunications services are supplied[123]

▪ the legitimate business interests of the carrier or carriage service provider concerned, and the carrier's or provider's investment in facilities used to supply the declared service concerned

▪ the interests of persons who have rights to use the declared service concerned

▪ the direct costs of providing access to the declared service concerned

▪ the operational and technical requirements necessary for the safe and reliable operation of a carriage service, a telecommunications network or a facility and

▪ the economically efficient operation of a carriage service, a telecommunications network or a facility[124]

This does not, by implication, limit the matters to which regard may be had.[125]

A more detailed discussion of these legislative criteria and their application in determining access pricing principles can be found in *Access Pricing Principles – Telecommunications – a guide*[126] (the APP paper).

9.2 Responses to the discussion paper

ACN

ACN submitted while retail-minus pricing was appropriate in 1999, it is now increasingly flawed and open to exploitation by Telstra:

> … Telstra's practice of pricing local/access significantly lower as part of its bundled offerings than the unbundled price used for calculating LCS, completely undermines the retail minus approach.[127]

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[123] s. 152AB(2) of the TPA.

[124] s. 152AH(1) of the TPA.

[125] s. 152AH(2) of the TPA.

[126] ACCC, *Access Pricing Principles Telecommunications – a Guide*, 1997.

[127] Australian Communications Network, *Local Services Review 2005: Submission by Australian Communications Network Pty Ltd*, 3 June 2005, p. 7.

ACN also stated that the retail-minus approach is inconsistent with the ACCC's approach to pricing other declared services, including local/access type declarations such as PSTN O/T and ULLS. ACN argued that a geographically averaged Total Element LRIC approach, such as that adopted by the FCC, may be more appropriate so as to provide competitors flexibility with regard to which elements of the bundle (i.e., local calls, other calls, access and related services) they want to provide.

Competitive Carriers' Coalition

The CCC submitted that the LCS pricing principles should be changed from retail-minus to a cost-based approach, with a wholesale cap for calls.

> That is, the wholesale price of the LCS should be charged on the same basis as interconnection rates for wholesale PSTN originating and termination rates, reflecting the recovery of the cost of infrastructure and systems necessary to deliver the service to the particular access seeker.
>
> While the retail minus pricing principle approach has the benefit of simplicity of implementation, it does so at the cost of consistency across the treatment of related services. There would seem to be no need to continue this inconsistency if costs are fully recovered.[128]

Optus

Optus submitted that the current regulatory construct for LCS is leading to higher prices for long distance and other bundled services. A retail-minus construct with a starting point of Telstra's unbundled local calling price could not in Optus's view be in the interests of end-users.

That said, Optus argued that:

> … it may be that other arrangements, specifically the Government's retail price control regime, may provide some protection from Telstra's conduct. Indeed the retail price controls may be appropriate protection given it is the combination of the ACCC's approach to LCS pricing and retail price cap arrangements that motivate Telstra's conduct.[129]

Optus concluded that the ACCC should:

> … adopt a TSLRIC pricing principle for each of the LCS and WBA services where the price is found to be less than RMRC.[130]

However, Optus closed its submission by setting out its 'Bridge to Broadband' proposal, under which it would promise to roll out competitive infrastructure in return

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[128] Competitive Carriers' Coalition Inc, *Submission to the ACCC Local Services Review*, June 2005, p. 5.

[129] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 15.

[130] ibid., p. 9.

for apparently arbitrarily determined LCS and line rental prices of 10 cents per call and $25 per month respectively.

Southern Phone Company

Southern Phone Company submitted that:

> … any LCS declaration must recognise the circumstances of regional Australia and allow a continued cross subsidy in service provision between regional and metro areas. [131]

Telstra

Telstra, in its submission, stated:

> In Telstra's view the long-term interest of end-users, and in particular the ACCC's objectives for sustainable infrastructure-based competition in telecommunications, require that the pricing of LCS and wholesale basic access move toward recovery of efficient costs.[132]

Telstra also submitted that:

> …the application of RMRC…results in further inefficiency because the deduction of 'avoidable' rather than "avoided" costs fails to fulfil the purpose of RMRC, that is to render an access-provider indifferent between retail and wholesale supply, and encourage efficient supply. In the event that the ACCC persists with RMRC, then retail costs actually avoided must be used, PSTN originating and terminating access prices must be adjusted to ensure cost recovery … and unbundled starting prices must continue to be used to minimise the "ratchetting down" effect [i.e., Telstra's wholesale price falls in response to a fall in retail prices].[133]

Telstra further stated that it:

> … advocates joint pricing of LCS and wholesale basic access to ensure cost recovery across the services and to permit flexibility by negotiation between access seekers and access providers, enabling both to price more innovatively.[134]

9.3 Relativity between costs and retail prices

As indicated by the above quotes, market perceptions of the costs of providing the declared services differ. In the course of this inquiry, Telstra submitted that:

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[131] Southern Phone Company, *Submission to Local Carriage Services Review*, July 2005, p. 4.

[132] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 2.

[133] ibid., p.4.

[134] ibid.

- The TSLRIC[135] of wholesale line rental is **[c-i-c]** (PIE II estimate, 05/06, GST exclusive); and

- The TSLRIC of a wholesale local call is **[c-i-c]** (PIE II estimate, 05/06, GST exclusive, ADC exclusive)[136]

No other participants submitted robust cost estimates in the course of this inquiry to substantiate their claims with respect to the costs of providing the declared services. Submitting parties however previously provided estimates in course of the ACCC's assessment of Telstra's core services undertakings[137]:

- Optus claimed that adjusting the PIE II model to the ACCC's preferred inputs would result in a TSLRIC price of local calls of **[c-i-c]** cents in 2003-04[138] and

- AAPT suggested that reasonable adjustments to call holding times in the PIE II model would result in a TSLRIC price of local calls of **[c-i-c]** cents.[139]

Following recent price increases, Telstra's prices for Homeline Part are now $31.95 (inclusive of GST, $29.04 exclusive of GST) and **[c-i-c]** (inclusive of GST, **[c-i-c]** exclusive of GST) for wholesale line rental.

Telstra's maximum allowable retail local call prices are 20 cents, exclusive of GST. The ACCC has previously accepted wholesale prices for local calls of 13.61 cents as proposed in Telstra's undertaking prices for the 2004-05 year.

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135 While it is not clear from Telstra's statements, the ACCC has presumed that its TSLRIC estimates are in fact TSLRIC+ estimates.

136 Telstra presented estimates for the ADC exclusive TSLRIC of local calls [**c-i-c**] in 2005-06, rising to [**c-i-c**] by 2007-08 in its main submission, whereas the estimated TSLRIC of wholesale line rental was contained in a separate presentation to the ACCC. At this stage, the ACCC has presumed that the estimates are consistent.

See: Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 27 and Telstra Corporation Limited, *Local services inquiry*, August 2005, p. 5 (confidential).

137 See: ACCC, *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004.

138 Optus, *Optus Submission to the Australian Competition and Consumer Commission on Telstra's Undertaking for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service,* March 2004, p. 35.

139 AAPT, *Telstra's Undertakings for Domestic PSTN Originating and Terminating Access, Unconditioned Local Loop Service and Local Carriage Service: Submission to the ACCC by AAPT Limited*, August 2003, p. 60.

Accordingly, the ACCC notes that, relative to the conditions in place at the time of previous assessments, the gap between TSLRIC+ costs estimated by Telstra's PIE II model and access prices has narrowed significantly, primarily due to substantial increases in the wholesale price for line rental.

As previously identified by the ACCC in its assessment of the core services undertakings, appropriately defined TSLRIC+ costs of providing local calls and line rental are likely to have declined significantly in recent periods, and may now be below access prices set under the current pricing approach.[140] While Telstra estimates appear to place the TSLRIC+ costs at slightly above access prices, the ACCC considers that these estimates are not robust.

The ACCC has consistently outlined its concerns with respect to the ability of the PIE II model to produce reasonable estimates of TSLRIC+. The ACCC has consistently adjusted the model (albeit in a severely limited fashion) in order to produce what the ACCC considers to be the conservative upper bound of the range of reasonable TSLRIC+ estimates. However, the ACCC has consistently reiterated that it uses the PIE II model only in the absence of a robust alternative cost model, and its use of the PIE II model in this way should not be construed as acceptance of its reasonableness. Regardless, the ACCC notes that given the close relativity between even Telstra's unadjusted PIE II estimates for 2005-06 and current access prices, it is likely that adjusted PIE II estimates for the period are likely to either eliminate the gap, or potentially result in Telstra earning positive margins on access prices for these services. Further, while it is difficult to be definitive at this stage as to the estimates which would be produced by a robust and independent alternative cost model, the ACCC reasonably expects that the estimates produced would likely result in TSLRIC+ estimates being below access prices set under the current approach.

However, given that at this stage a robust and independent alternative model does not exist, the ACCC cannot be definitive in this regard. Accordingly, the ACCC has conducted its assessment of the reasonableness of alternative pricing principles with respect to where costs are both above, and below retail prices.

9.4 Reasonableness of alternative pricing principles under s. 152AH

The LCS and wholesale line rental services currently offered by Telstra are priced in accordance with 'Option 1' as outlined by the ACCC in the Discussion Paper.[141] That

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140 ACCC, *Assessment of Telstra's Undertakings for PSTN, ULLS and LCS – Final Decision*, December 2004, p. 52.

141 ACCC, *Local Services Review 2005*, April 2005, pp. 47-48.

is, the LCS is priced on a retail-minus retail cost (RMRC) basis, with the retail cost adjustment to the LCS incorporating retailing costs for both the LCS and line rental. Wholesale line rental is priced to the access seeker without adjustment for retail costs.

In the Discussion Paper, the ACCC requested submissions on the appropriate pricing principles to apply to any continued declaration for the LCS, and/or any new declaration of a wholesale line rental service. The ACCC sought comment on both the RMRC principle and a form of cost-based alternative.

The ACCC's assessment has been conducted with respect to these two broad pricing principles. In this regard, the ACCC notes that it has effectively applied a modified 'with and without' test to the assessment of alternative pricing principles. That is, the ACCC has assessed the outcomes which could reasonably be expected given prevailing market conditions under an RMRC pricing principle, and compared those outcomes with those which could be expected where the ACCC chose to apply a cost-based pricing principle. Specifically, the two alternatives are contrasted against each other under the respective criteria set out in s. 152AH to provide a comparative analysis of their ability to best fulfil those criteria.

An overall conclusion on the most appropriate method given these considerations with respect to each criterion follows. Specific implementation issues are discussed separately below.

9.4.1 The long-term interest of end-users

9.4.1.1 Promotion of competition

Broadly, the ACCC regards anything that promotes (damages) competition, everything else being equal, as enhancing (damaging) the LTIE. In the context of considering whether a given pricing principle will promote competition, it is appropriate to examine the impact of the proposed principle on the relevant markets, and compare the state of competition in those markets relative to the application of the alternative principle.

Where costs are above retail prices, an RMRC approach is likely to promote competition in the retail markets for LCS and line rental. Such a principle provides for competitive neutrality between Telstra and access seekers at the retail level for these services.

The ability of a cost-based approach to promote competition is difficult to determine in the absence of firm information with regards to the level of network costs relative to retail prices.

Optus stated that:

> … it may be reasonable to define a market for local calling services in rural and regional areas… In these areas it has been suggested that Telstra holds the price of its services below

> cost… However, it is questionable as to whether prices are being held below cost. As has been argued by Optus in its submission on Telstra's core service undertakings and the PIE II cost model estimates, the actual cost of supplying services in these areas may be lower than estimated.[142]

Telstra has stated that it is currently the case that geographically-averaged costs for these services are above retail prices, and that as a result competitive neutrality requires the adoption of a cost-based pricing approach for these services so that these losses can be 'shared' by access seekers:

> Competitive neutrality requires that access seekers purchase wholesale services at cost-based prices and share responsibility for losses at the retail level, instead of imposing all the losses on Telstra. [143]

Where costs are above retail prices, it is reasonable to conclude that the adoption of a cost-based pricing approach has the potential to be detrimental to competition. Such a principle is unlikely to allow for entry of efficient competitors to the downstream market.

Telstra's claims appears to be that in the absence of declaration, it must be receiving cross-subsidies from other sources which it would no longer acquire upon the provision of access, and that these subsidies are not merely consequential profits but required to compensate for any shortfall, as discussed below with respect to Telstra's legitimate business interests.

Accordingly, in order for a cost-based approach to promote competition in these circumstances, the ACCC would need to be satisfied that access seekers would equally be able to cross-subsidise any loss from the same sources to which Telstra has access. Telstra provides a range of services across the CAN, and has access to cross-subsidies through above-cost pricing on other services which may be related to line rental such as voice services, external funds such as the Universal Service Fund and other Government subsidy programs, or unrelated services such as wholesale and retail xDSL services. Where access seekers have equal access to all such subsidies, competition is unlikely to be harmed through the adoption of a cost-based approach.

Where this is not the case, cost-based prices are likely to be detrimental to competition. Further, the inhibition of resale-based competition may be detrimental to the development of facilities-based competition, as discussed below.

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142 Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, p. 14.

143 Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 49.

Where costs are below retail prices the adoption of a cost-based pricing approach to the declared services is likely to affect competition in several ways. Mandating access prices under an RMRC principle in these circumstances would, in the short-term, limit their ability to compete with Telstra which would both face a lower cost structure and earn economic profits which could potentially be used by Telstra for the purposes of constraining competition in downstream markets.

However, it is noted that cost-based access alternatives, as well as the development of bypass alternatives are potentially available to access seekers in these circumstances. Therefore, a further relevant consideration is the extent to which, under these circumstances, a move to cost-based prices would impact on competitive entry via the construction of competing facilities.

The ACCC considers that there is no firm evidence on which to form conclusions as to whether the declaration of the LCS has promoted competition by improving the conditions for facilities-based entry. Accordingly, the ACCC considers that the transition to facilities-based competition remains a relevant consideration under the promotion of competition objective.

The ACCC considers that the declared services continue to act more as a complement, rather than a substitute, to more sustainable forms of competitive entry. Accordingly, the ACCC is of the view that moving to a cost-based pricing structure may impact on this relationship in two ways. On the one hand, it may diminish the incentives for access seekers to switch to facilities-based alternatives by reducing the level of potential profits available from such a switch. On the other hand, by equating their access prices to Telstra's costs, Telstra's ability to restrict resale competition and inhibit potential switching over time to facilities-based competition will be reduced.

Accordingly, while the ACCC has no firm view at this stage as to which approach may be more able to promote sustainable competition, but it is likely that on balance, where costs are below RMRC access prices, competition is more likely to be promoted by a cost-based approach.

However, Optus considers that facilities-based competition is best promoted by a pricing principle which explicitly lowers prices for the declared services to this end. Optus states that:

> Optus believes that at this stage of the market's development, the ULLS service offers the best prospect of injecting competition into the market for LCS services… Optus sees clear benefits in using pricing of the LCS service to promote uptake of the ULLS service, which will in turn promote competition in the provision of LCS services.
>
> The ACCC's pricing of LCS services to date has failed to enable access seekers to obtain sufficient scale in their customer bases to reduce risks associated with deploying the ULLS infrastructure to acceptable levels. At the same time, it has not achieved the ACCC's stated objectives on ensuring access prices do not promote undue reliance on the wholesale LCS service.

> Optus' "Bridge to Broadband" proposal recommends that LCS pricing be structured so as to strike an appropriate balance between these two factors. Specifically, under Bridge to Broadband, in exchange for better LCS prices, carriers would commit to rolling out new broadband infrastructure.
>
> Optus proposes that the wholesale local call resale price be set at 10 cents and monthly line rental be set at $25. In return, providers such as Optus would enter into a Network Development Deed making specific DSL build commitments. Arrangements would remain in place for a defined three year period – by the end of which time Telstra's competitors would be expected to have shifted their traffic substantially onto their own ULLS network.[144]

In effect, Optus has stated that facilities-based entry would be better served by lower (and presumably below cost) access prices for resold services, set on the condition that access seekers would make specific commitments to build infrastructure, in order to enable potential facilities-based entrants to more rapidly attain market share prior to the deployment of the committed facilities. The ACCC remains concerned that a proposal of this form may be inappropriate under the statutory criteria, and continues to consider that facilities-based competition is best promoted by other pricing approaches.

At this stage, it is difficult to form firm conclusions on relative abilities of the proposed pricing principles to promote competition. However, the ACCC believes that where costs are above RMRC determined access prices an RMRC approach is more likely to effectively promote competition in the retail market for the declared services, while providing reasonable incentives and opportunities for facilities-based competition to develop. However, where costs are below RMRC determined access prices, it is likely to be the case that the adoption of a cost-based approach would more effectively promote competition.

9.4.1.2 Efficient use of infrastructure

Efficient use of infrastructure is interpreted in standard economic efficiency terms of moving prices closer to underlying costs to achieve a closer matching of users' valuation of the services, at the margin, with the cost to the economy of providing those units.

An RMRC approach is likely to have only a limited direct impact on the efficient use of infrastructure. That is, efficiency gains from an RMRC approach are likely to be confined to productive efficiency gains in the retailing of line rental and local call services, by providing firms with the appropriate incentives to produce retail services at least cost. Where current retail pricing constructs are allocatively inefficient in terms of reflecting the valuation of the resources employed to provide those services, either through below-cost pricing as a result of retail price controls or above-cost pricing due

[144] Optus, *Optus Submission to Australian Competition and Consumer Commission on Local Calling Service Regulation*, July 2005, pp. 19-20.

to Telstra’s market power over retail services, an RMRC approach is not likely to be able to significantly address any such inefficiency.

However, as noted above, an RMRC approach has the ability to promote widespread low-cost entry into the retail market for the declared services. This could potentially act to lower barriers to entry into the wholesale markets for line rental and local call services, through promotion of facilities-based competition. An RMRC approach may therefore lead to significant dynamic and productive efficiency gains, by improving the incentives faced by both Telstra and emerging facilities-based competitors to innovate, improve the range and quality of services, increase productivity and lower the costs of production over time through improved competition at the wholesale level.

A cost-based approach is ostensibly more likely to directly promote the efficient use of infrastructure. An appropriately implemented cost-based approach would seek to relate access prices to the underlying costs of provision, potentially leading to allocative efficiency gains which would be otherwise unattainable under an RMRC approach. However, the current commercial reality is that for the vast majority of end-users, Telstra bundles line rental and local calls extensively with other services, and its bundled rates are well below the maximum prices allowable for these services under retail price controls, and further below what it claims are the costs of provision. In the absence of significant changes to Telstra’s bundling practices, only minimal relative allocative efficiency gains could reasonably be expected to follow the adoption of a cost-based principle.

The impact of a cost-based approach on dynamic and productive efficiency is less clear. Where costs are above current retail prices, existing barriers to entry in both resale and facilities-based competition may be strengthened as identified above, with the inhibition of effective competition at both the retail and wholesale level detrimentally impacting on the ability of competition to drive efficiency in the use of infrastructure.

Where costs are below RMRC determined access prices an equating of access prices for declared services with costs, similar to other services such as the ULLS, is likely to best promote the efficient use of infrastructure. That is, the declared services provide only minimal product and quality differentiation opportunities for access seekers relative to the incumbent’s own retail offerings. Other factors such as the desire for product differentiation and value-added opportunities, decreased reliance on the incumbent, improved control over their own facilities and their access to the incumbent’s facilities are likely to provide sufficient incentives to invest in competing facilities and it is reasonable to conclude therefore that efficiency in use of infrastructure is more likely to be promoted by a cost-based principle.

Where costs are above RMRC determined access prices, an RMRC principle is more likely to promote the efficient use of infrastructure relative to a cost-based principle.

Where costs are below retail prices, an RMRC approach is unlikely to promote efficient use of infrastructure relative to cost-based prices.

9.4.1.3 Efficient investment in existing and new infrastructure

This criterion has been interpreted by the ACCC as providing incentives for Telstra and other potential facilities-based entrants to make economically-justifiable investments in the infrastructure by which the declared services are provided.

Telstra has stated that as retail prices are currently below costs, a cost-based approach to access pricing must be adopted in order to ensure that incentives for efficient investment are maintained.

> Given that the ACCC has a goal of encouraging infrastructure competition, it would appear fundamental to such an outcome that the prices faced by access seekers for the LCS and any declared basic access reflect the efficient costs that are incurred in providing these services. This is because such prices will enable competing providers to make investment decisions based on the true resource costs of the build and buy options they face.[145]

The ACCC notes that the constraint identified by Telstra arises out of the imposition of retail price controls upon it, which would similarly constrain the ability of competing providers to recover their efficient investment costs were they to invest on a comparable basis to Telstra. Facilities-based competitors still need to compete against Telstra's constrained retail prices. If Telstra is being required to price below cost for local calls by the retail price controls, new investment by either Telstra or its competitors could potentially be discouraged.

In these circumstances, an RMRC approach is relatively more likely than a cost-based pricing approach to encourage efficient facilities-based competition. An RMRC approach is likely to promote incentives for efficient investment in retailing of the declared services. Further, resale entry reduces the risks associated with network investment, and can encourage more efficient use of telecommunications infrastructure by promoting productive efficiency. Alternatively, the use of a cost-based approach is likely to diminish the ability of competitors to engage in competition through the declared services, and reduce the risks associated with new investment.

Another way of looking at this issue is to note that any underlying distortions to investment result from constraints on retail pricing rather than the RMRC approach. The RMRC approach is aiming to promote more efficient investment outcomes given current constraints and is, if anything, aiming to foster more efficient longer-term outcomes rather than creating sub-optimal results.

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[145] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 49.

Where costs are below retail prices, the ACCC considers that a cost-based pricing principle is more likely to promote efficient investment in existing, and new infrastructure.

On balance, where these services are viewed in isolation neither an RMRC principle nor a cost-based principle is capable of providing optimal incentives for efficient investment in the presence of binding retail price constraints. As identified, where costs are above RMRC determined access prices, an RMRC principle provides effective incentives for efficient investment in retailing of the declared services taking into account existing constraints, and may over time lead to efficient investment in facilities-based competition in the longer-term as access seekers undertake investment in. Where costs are below RMRC determined access prices, retail price controls are no longer binding and efficient investment is more likely to be promoted by a cost-based pricing principle.

9.4.1.4 Any-to-any connectivity

Any-to-any connectivity is not likely to be affected by the choice of pricing principle to be applied to the declared services.

9.4.2 Legitimate business interests

The legitimate business interests of access providers require an access price that at least provides a normal commercial return on prudent investment. However, it is unlikely the legitimate business interests of an access provider extend to achieving a higher than normal commercial return.

In considering this criterion, the ACCC is cognisant that the declared services are provided using the CAN. The ACCC has previously expressed the view that the CAN is the dominant source of Telstra's market power and that it is likely to continue to invest in the CAN for strategic reasons. Consequently, the strategic returns to Telstra would have to be considered at the same time as Telstra's return from this particular service is considered.

Telstra claims that a cost-based approach will ensure its legitimate business interests are met in accordance with this criterion. The ACCC considers that where costs are found to be above the maximum prices allowed for these services under the retail price controls for the declared services, it is reasonable to conclude that in the absence of declaration of these services Telstra would be equally unable to recover these costs directly through retail prices for these services.

In order to recover its costs where these claims are accepted, Telstra must receive sufficient contributions from other sources to alleviate this shortfall. Alternatively, Telstra would be in a situation of forced losses as a result of retail price controls, and in this case it is not clear why access prices should be set to compensate Telstra for a loss it would otherwise be incurring in the absence of declaration. Additional sources of funds include Universal Service levies, other Government subsidies, and economic profits earned from the provision of services across the CAN which may or may not be related to the declared services. Telstra's claim for a cost-based approach would therefore appear to centre on whether or not the provision of access to the declared services would inhibit its ability to access any of these contributions, and whether or not any particular subset of these contributions is in fact required and is not in fact an above normal return acquired through the application of its market power in related services.

In this regard, it is noted that an access seeker procuring the declared services is likely to bundle these services with other voice services in the retail market. Accordingly, Telstra would need to demonstrate that all of the contributions required to fund any shortfall would otherwise have been received from the above-cost pricing of those related voice services, and that there are no other relevant sources of funds to be accounted for.

Telstra does receive contributions from industry and Government subsidy programs as well as potentially the provision of other services such as wholesale and retail xDSL. Telstra's own Chief Financial Officer has made statements to this end:

> Telstra's finance chief John Stanhope made a very telling comment at a recent investment bankers' conference. The advent of high-speed internet services using DSL over copper wires was the very best thing that could have happened to Telstra, he said. This is because it allows Telstra to pay for its national copper and fibre network a second time. A double dip on returns on capital. Nothing could make a CFO's heart sing louder, Stanhope mused.[146]

However, Telstra's submission states that:

> Neither Telstra's retail nor wholesale prices for ADSL services include a contribution to the CAN line costs.[147]

The ACCC considers that it is difficult at this stage to determine the extent of any contributions Telstra may be earning from these services, based on these and other conflicting statements. However, the ACCC considers that the existence of industry and Government subsidy programs, as well as the possibility that additional service contributions may exist are clearly relevant considerations for the analysis of Telstra's legitimate business interests.

Telstra's access to these and other contributions is not likely to be inhibited by the provision of access to the declared voice services and any related voice products bundled with the declared services. The ACCC notes the current close relativity

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[146] M. Sainsbury, 'Coonan's out of the loop on separation', *The Australian*, 23 June 2005, p. 27.

[147] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 42.

between retail prices and costs, and considers that in the absence of a full identification and quantification of the range of contributions Telstra receives, the continued use of an RMRC pricing principle is in effect a judgement that Telstra is currently capable of ensuring its legitimate interests are met by fully acquitting any estimated shortfall through contributions from sources other than related voice products.

Where these cross-subsidies are not accounted for in reductions to access prices for the declared services, a considerable risk remains that Telstra would over-recover its costs through a shift to an unadjusted cost-based pricing principle. While the recovery of costs is reflective of Telstra's legitimate interests, recovery of amounts above costs is not. Accordingly, the ACCC is of the view that any determination of cost-based prices where retail prices are below costs would require a threshold examination and accounting of Telstra's revenue sources, and more generally its profitability across the range of services it provides prior to making any determination.

9.4.3 The interests of persons who have rights to use the declared services

The interests of persons who have rights to use the declared service are best served by a pricing principle which provides them with a reasonable opportunity to compete in the market. The interests of persons who have rights to use the declared services would also appear to be served by minimising any regulatory uncertainty which may arise through changes to pricing principles.

The ACCC considers that a continuation of the RMRC pricing principle is likely to provide access seekers with a reasonable opportunity to compete in the retail market for local calls and line rental where costs are above RMRC determined access prices. However, where costs are below retail prices, it is likely to be the case that the interests of persons who have rights to use the declared services are relatively more likely to be met by the adoption of a cost-based pricing principle. A transitional glide path would be adopted where a cost-based pricing approach was chosen in order to minimise regulatory uncertainty for access seekers.

9.4.4 Direct costs of providing access to the declared services

Direct costs are those costs necessarily incurred in the provision of access. This criterion requires that an access price should not be inflated to recover any profits the access provider may lose in a dependent market as a result of the provision of access.

Where costs are below RMRC determined access prices, it is likely to be the case that an RMRC principle is inconsistent with this criterion as it will not reflect Telstra's direct costs. A cost-based principle is more likely to be consistent with this criterion where costs are below retail prices.

Where costs are above retail prices, it is unclear whether these costs are direct costs for the purposes of this criterion. That is, the ACCC notes that in the absence of declaration Telstra would be constrained by retail price controls from recovering these costs directly from the services in question. However, the provision of access under these circumstances in no way alters Telstra's inability to recover these costs directly from the declared services, and therefore it is difficult to conclude that these costs represent direct costs of providing access.

Accordingly, the ACCC considers that this criterion suggests that an RMRC principle is most appropriate where costs are above retail prices. Alternatively, a cost-based principle should be used where costs are below retail prices.

9.4.5 Operational and technical requirements

Operational and technical requirements are not likely to be affected by the choice of pricing principle to be applied to the declared services.

9.4.6 ACCC's draft view

As is readily apparent from the above analysis, the relativity between costs and retail prices is a determinative factor in the assessment of the reasonableness of the alternative pricing principles under each of the criteria.

As outlined in section 9.3, Telstra's estimates for the 2005-06 year suggest that TSLRIC+ costs remain above retail prices for local calls (and are projected to rise over the coming period), but at or slightly below retail prices for unbundled line rental.

While the ACCC continues to have reservations about the ability of PIE II to produce reasonable TSLRIC+ estimates, it notes that in the absence of a robust independent cost model little alternative guidance is available to it at this stage.

Accordingly, in line with the above analysis, the ACCC's draft view is that a continuation of the RMRC approach to the pricing of the declared services as an interim approach is reasonable under the statutory criteria at this stage.

The ACCC has relied upon the evidence presented to it by submitters to the Discussion Paper, as well as its own analysis to form a judgement as to which approach is relatively more able to promote each of the statutory criteria. It is the ACCC's draft view that, an interim RMRC approach is likely to promote the LTIE in relation to the declared services as it:

- Is likely to promote competition in the retail markets for the declared services, and is more likely to promote facilities-based competition
- Is likely to promote the efficient use of infrastructure
- Is likely to promote efficient investment in infrastructure

- Is less likely to ensure Telstra's legitimate business interests are met, depending on further examination of the full range of subsidies available to Telstra
- Serves the interests of those who have a right to use the declared services and
- Is likely to ensure the direct costs of providing the declared services are met.

However, in making this draft determination, the ACCC acknowledges that the majority of submissions favour an alternative pricing principle – that is, a cost-based pricing principle. The ACCC notes that while submissions generally favoured cost-based pricing for these services, the perceptions of the market informing these submissions were markedly different. The preferences of access seekers for cost-based prices were conditional upon finding that a shift to cost-based pricing would result in access prices below those which would be set under an RMRC principle.

There is no clear consensus on the differential between retail prices and costs. In general, access seekers appear to believe that a cost-based principle would result in lower access prices, while Telstra believes that a cost-based principle will result in higher access prices. The ACCC reiterates that the conclusions underlying the continued use of RMRC as an interim approach are finely balanced, and heavily dependent on this relativity. The ACCC is concerned that there is currently a significant level of uncertainty within the market as to what constitutes a reasonable estimate of the costs of providing a range of fixed network services, including the declared services under consideration in this review.

As outlined in section 9.3, the ACCC is mindful of the relatively narrow gap between Telstra's estimated costs and current access prices compared to previous periods. The ACCC notes that this gap has narrowed significantly since the last pricing principle determination.

The ACCC therefore considers that it is appropriate and timely to pursue the development of a robust and independent cost model, with a view to determining whether cost-based pricing principles for these services will be appropriate going forward. The ACCC clear preference is not to rely upon Telstra's PIE II model for estimating the costs of providing the declared services.

The ACCC notes that any cost model it develops will also provide useful guidance with respect to the ACCC's other regulatory responsibilities in relation to a range of fixed services, including the ULLS, LSS and PSTN O/T. In preparing for such an exercise, the ACCC welcomes input from all interested stakeholders with respect to the appropriate scope of any cost model, and views as to the range and values of relevant inputs and assumptions.

However, in pursuing this task, the ACCC reiterates that cost modelling, of its nature, is a complex and time-consuming process. The ACCC therefore considers that, while cost-based pricing is likely to constitute the preferred option for pricing the declared services, pending the findings of a robust cost modelling exercise, it would not seek to implement such an approach until any such independent cost model was capable of providing robust estimates for the declared services. Until that time, and based on the above analysis, the ACCC's draft view is to continue the application of an RMRC pricing principle to the declared services as an interim approach.

9.5 Implementation Issues

9.5.1 Avoidable or avoided costs

Telstra has submitted that:

> … The ACCC's application of the retail-minus approach (ie RMRC) involves deducting average retail (avoidable) costs from the starting price and for this reason, promotes the inefficient supply of local calls in the retail market.
>
> A retail-minus pricing principle should make the access provider indifferent between supplying at retail or wholesale levels. The only way that this is possible is if avoided costs are used in the calculation. These are the costs that the LCS provider can actually avoid when it sells a local call at the wholesale rather than the retail level. However, rather than being based on the costs that are avoided, the ACCC's application of RMRC is based on an average retail cost standard.
>
> Use of avoided costs is more consistent with economic efficiency. This is because an access seeker can only earn a margin on the provision of local calls if it can provide the retail functions cheaper than costs avoided by the LCS provider. If this is the case then it is efficient, from a productive efficiency perspective, for the access seeker to supply the local calls, as the total cost to the community will be lower than if the LCS provider continued to retail all local calls.[148]

The ACCC has previously stated its preference for the use of avoidable costs, rather than those costs actually avoided by Telstra.

Telstra has in effect argued for a short-run focus when claiming that the ACCC should ensure that Telstra is 'indifferent' to supplying at the wholesale and retail level through the use of avoided costs. By definition, avoided costs must be a short-run concept, as in the long-run all costs can be avoided, and therefore avoided costs would equate to avoidable costs.

The ACCC considers that the best characterisation of the appropriate level of retail costs to be deducted is a measure of those costs which Telstra can avoid in the long-run. In the long-run, should Telstra cease to retail the declared services, all retail costs

[148] ibid., p. 25.

are avoidable. Accordingly, the use of an avoidable cost standard ensures that Telstra is indifferent between supply at the retail and wholesale levels in the long-run.

Telstra also refers to the use of avoided costs being productively efficient. The ACCC accepts that, in the presence of fixed costs in retailing (fixed costs in retailing are discussed further below), this is likely to be the case. However, such considerations are counterbalanced by dynamic efficiency considerations. The use of avoided costs would tend to preclude the entry of access seekers that are more efficient in retailing in the long-run. The avoidable cost standard, while potentially leading to static productive inefficiencies, is more likely to lead to dynamic efficiency gains through competitive pressure imposed by access seekers and is therefore preferred on this basis.

Telstra claims that:

> …the ACCC's RMRC approach encourages inefficient entry and raises the total cost of supply to end users. Indeed, inefficient entry could continue up to the point where the entire gap between average retail costs and truly avoidable retail costs had been dissipated, presumably by duplication of the fixed costs of retailing.
>
> The effect of the ACCC's RMRC approach is exacerbated as the volume of retail local calls decline and the majority of retailing costs are not avoidable, resulting in inefficient and unsustainable LCS prices.[149]

It is not clear how inefficient entry could be expected to occur under Telstra's scenario. Telstra is, in effect, claiming that some proportion of the costs of retailing the declared services is invariant with demand, ie. fixed. Under these circumstances, it is reasonable to expect that an access seeker is likely to incur a similar level of fixed retailing costs. However, given the average cost calculation employed to determine avoidable costs, it is reasonable to conclude that due to Telstra's superior scale, its average costs will be lower than any access seeker's average costs. Telstra's arguments in favour of the use of only avoided costs so as to avoid inefficient entry appear to fail to take account of this effect. In these circumstances, it is reasonable to expect that in the short-run, access seekers would in fact need to be either substantially more efficient than Telstra in retailing, or alternatively more readily able to scale their operations in response to changes in demand

The use of avoided costs would also constitute a requirement that access seekers make a contribution to Telstra's fixed costs in retailing, as well as incurring their own costs. Such a contribution would be at odds with the requirement to consider the interests of persons who have a right to use the declared services criterion.

[149] ibid., p. 27.

The ACCC notes that TelstraClear, a subsidiary of Telstra, has presented arguments to the New Zealand Commerce Commission clearly at odds with the position currently being adopted by Telstra in relation to the declared services:

> The policy rationale for providing for resale is that it will promote efficiency by lowering the overall costs of retailing. Provided that the discount a reseller faces reflects efficient costs a reseller will only enter the market if it is more efficient than the incumbent in providing the service, in terms of total directly attributable costs; but if a reseller's costs are greater than those of the incumbent it will be prevented from entering.
>
> However, for price-capped residential local access services actual costs saved would appear to introduce an inappropriate wedge between the incumbent's costs and a reseller's by failing to eliminate all the relevant costs of the incumbent and raising the costs of the reseller. As a result, even if the reseller were more efficient than the incumbent it would still be prevented from entry or, in the event that it did enter under the initial discount of 2% in the hope that the actual costs standard was revisited, it would be forced out of the market if the standard remained unchanged. As Ordover and Klick commented:
>
> "Because resellers must incur their own retail costs to enter the market, failure to eliminate the full amount of the incumbent's long-run avoidable retail costs as part of the wholesale discount creates a risk that the spread between the input cost (wholesale price) and the price of the output would not allow an efficient reseller firm to compete effectively. Companies seeking to enter the market using resale – even if they are as efficient or more so than the incumbent – would be prevented from doing so because they effectively would be forced to incur both their own long-run retail costs and also defray a portion of the incumbent's avoidable (in the long-run) retail costs as a component of the wholesale rate."[150]
>
> …The avoidable costs saved discount would therefore be a more appropriate final pricing principle for price-capped residential local access services than actual costs saved.[151]

The ACCC considers that its analysis of this issue is more reasonable under the statutory criteria than the position advanced by Telstra, and notes TelstraClear's agreement in this regard.

Further, any use of avoided costs, rather than avoidable costs, is likely to confer upon Telstra an undesirable level of discretion in the determination of avoided costs. Telstra is likely to face strong incentives to minimise the level of costs avoided (with resulting efficiency losses in retailing across the market), in order to unreasonably inflate access prices in ways which are likely to be contrary to the LTIE. Were an avoided cost standard to be applied, given the strong informational asymmetries between Telstra and

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[150] Ordover, J.A. and Klick, J.C., *Issues Raised by the Commerce Commission's 30 September 2004 Paper Entitled Avoided and Actual Costs Saved: Application of the Final Pricing Principle*, 22 October 2004, page 7.

[151] TelstraClear Limited, *Review of Designated and Specified Services under the Telecommuunications Act 2001: Proposals for Amendments to Services Commission has Decided to Investigate*, 21 December 2005, p. 5, 7.

the ACCC it is unlikely that the ACCC would be in the position to reasonably monitor and correct any such conduct.

9.5.1.1 Conclusion

The ACCC's view is that avoidable costs remain the most appropriate measure for retail costs under the RMRC standard. Avoidable costs provide superior incentives for equally or more efficient service providers to enter the retail market for the declared services.

9.5.2 Benchmark retail price

When adopting a RMRC methodology, it is necessary to determine the appropriate retail price benchmark to be applied. In the past, as noted in the Discussion Paper, in applying RMRC the ACCC has considered it appropriate to use Telstra's unbundled retail local call offering as the retail starting price to determine suitable LCS access prices. Through the use of 'Option 1', line rental prices have been similarly determined. Telstra's unbundled offering is a retail local call and line rental price absent pre-selection of Telstra for STD, IDD and FTM call services. These offerings presently comprise Telstra's HomeLine Part and BusinessLine Part retail products. In contrast Telstra's bundled offerings are retail local call and line rental services with pricing conditional on preselection to Telstra for STD, IDD and FTM call services. Current examples of these are Telstra's HomeLine Complete and BusinessLine Complete offerings.

In addition, Telstra bundles its fixed-line telephony services with other services such as mobile telephony, internet and pay TV services. As part of this bundling, Telstra offers various discounts such as free local calls further reducing the bundled price of a local call.

The ACCC has recognised that Telstra could potentially price-squeeze its competitors by influencing the differential between its unbundled local call prices relative to its bundled local call prices.[152] Further, by bundling other services with fixed-line telephony, Telstra could further reduce bundled local call or line rental prices. The ACCC therefore indicated in its previous pricing principles for the LCS that it would monitor the market and revisit this approach if it believed there was evidence of a price squeeze.

The ACCC has continued to monitor this situation since 2002. In particular, its concerns have very recently been heightened through increases to Telstra's unbundled and wholesale prices relative to its bundled prices. These changes are currently the

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[152] See, for example, ACCC, *Final Determination for model price terms and conditions of the PSTN, ULLS and LCS services*, October 2003, pp. 89-93.

subject of an ACCC investigation. Therefore, in consideration of the appropriate price, the ACCC clearly has two options:

- continue the use of unbundled local call and line rental prices or

- move towards the use of Telstra's bundled prices.

9.5.2.1 Unbundled prices

The use of unbundled prices escapes unintended consequences which may arise through the use of bundled prices. That is, where facilities-based competition develops in the market, Telstra is relatively free to respond to competition in the pricing of its services without being required to pass through these responses to regulated access prices for the declared services. The use of unbundled prices retains Telstra's flexibility to respond in circumstances of genuine competition without forcing, but nevertheless leaving it the option to reduce prices for access seekers from unbundled levels. This is discussed further below.

However, the availability of these longer-term opportunities to switch is unlikely to adequately address any concerns in relation to potentially anti-competitive price squeezing behaviour by Telstra in the short-term. That said, these concerns appear to be able to be more adequately addressed by the use of Part XIB in conjunction with the adoption of any broad unbundled RMRC pricing principle.

9.5.2.2 Bundled prices

The use of bundled prices is likely to be more able to directly address issues of anti-competitive price squeezing or exclusionary behaviour by Telstra, by directly relating access prices to the prices Telstra actually offers in the market.

Telstra states that:

> The use of a bundled starting price for LCS would limit Telstra's flexibility in setting retail prices for bundles of services. For example, Telstra may in the future want to change the structure of its retail pricing such that there will be no identifiable price for basic access and local calls. Rather, as other competitors are doing in the market, Telstra may wish to move to a structure of pricing that involves a single price for a bundle of services. This would make the use of bundled pricing for LCS impracticable. It would also limit Telstra's ability to offer innovative pricing structures in response to customer demand and competition.[153]

The ACCC agrees with Telstra that it is not desirable to limit its flexibility to offer lower and/or innovative pricing structures in response to competition and consumer demand. To the extent that the use of bundled prices as a benchmark for access prices

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[153] Telstra Corporation Limited, *Submission in Response to ACCC Discussion Paper Entitled 'Local Services Review 2005'*, 28 June 2005, p. 30.

for the declared services would limit Telstra's flexibility, the ACCC considers that this would act against the use of bundled prices.

Additionally, Telstra has attached significant weight to the potential for access seekers to engage in 'ratchetting down'. Ratchetting down is claimed to occur when access seekers lower their retail prices below Telstra's and Telstra lowers its retail prices to compete. While the ACCC is sceptical that the claimed strategy would be viable for access seekers, it nevertheless acknowledges that the potential for such a strategy exists, however small, and would also act against the use of bundled prices.

Presumably, given the range of bundles available in the market, if a bundled pricing approach was to be adopted for these services it would likely require implementation through an averaged revenue per user approach. However, in the longer-term any such approach is likely to create distortions in retail pricing market.

That is, in the event that facilities-based competition develops, either via the ULLS or alternative networks, Telstra's retail prices are likely to be increasingly subject to competitive pressure. To the extent that this competitive pressure may force Telstra's prices down, it is reasonably likely that the 'average' or bundled Telstra retail price will be under pressure to converge towards the cost of providing services in more heavily populated regions. There are therefore potentially unintended consequences of adopting this approach.

First, Telstra is relatively less likely to seek to pursue retail price reductions in competitive regions, as it will be forced to pass these reductions through to other regions via the resale price arrangements. Accordingly, any competitive strategy on Telstra's part is relatively more 'expensive', and to the extent that Telstra remains a strong price leader in the market it is relatively more likely to delay the widespread gains available to consumers through reduced prices as a result of facilities-based competition.

Second, to the extent that Telstra does reduce prices, any losses it may potentially be incurring in high cost regions are likely to be exacerbated, as Telstra is forced to pass on price reductions in low-cost regions to high-cost regions.

Third, there is potential for such an approach to allow for 'free-riding' by access seekers otherwise unwilling to commit to the development of their own facilities. That is, the ability to secure reductions in resale-based access prices under a bundled approach may diminish the incentives for some access seekers to invest in their own facilities, or to enter into unregulated resale arrangements with facilities-based competitors. They are therefore relatively more likely to be able to secure the benefits of such competition without investing in their own facilities and incurring a commensurate level of risk to those access seekers which have chosen to do so.

9.5.2.3 Conclusion

On balance, under an RMRC approach, the ACCC considers that unbundled retail prices for local calls and line rental are more likely to satisfy the relevant statutory criteria, in conjunction with the effective use of Part XIB to address any anti-competitive conduct concerns from Telstra's bundling practices where they arise.

9.5.3 Joint or independent pricing

None of the submissions made to the Discussion Paper considered that a one per-call price to recover both line rental and LCS costs was appropriate. The ACCC considers that this approach lacks the flexibility of other approaches.

Telstra argues for a bundled two-part tariff approach to pricing the LCS and line rental, suggesting that such an approach would provide flexibility in allocating common costs while still recovering the combined costs of provision of both services. While an RMRC approach would not involve the allocation of common costs, a similar challenge would be presented in attributing retail costs to each of line rental and the LCS. Telstra claims that pricing line rental and the LCS separately is undesirable because of the risk that the ACCC will incorrectly allocate costs between the two services.[154]

However, it is not clear to the ACCC why a bundled two-part tariff provides more flexibility or less risk than a separate pricing approach. If the ACCC determines broad pricing principles but does not calculate indicative prices for the declared services, access providers and access seekers are free to negotiate how costs should be allocated regardless of the pricing approach used. On the other hand, if the ACCC chooses to calculate indicative prices, both bundled and separate pricing approaches require the ACCC to make an allocation of costs between the two services. In this regard, the ACCC notes that Telstra suggests in its submission:

> ...under the current joint pricing mechanism, access seekers can purchase wholesale basic access at full retail prices and LCS at the retail price minus the combined (LCS + basic access) avoidable cost or basic access and LCS at their respective RMRC.[155]

The ACCC considers that the ability for access seekers to purchase line rental and LCS at their respective RMRC is essentially what an independent pricing approach would facilitate, and Telstra appears to be acknowledging that such an approach is both feasible and available under current practice, and the ACCC therefore sees no basis for not formalising its application. Further, the ACCC considers that as at this stage it is only determining relevant pricing principles, rather than indicative prices, it is not in any way limiting the flexibility of Telstra and access seekers to determine prices in circumstances where both of the declared services are purchased together.

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[154] ibid., pp. 60-61.

[155] ibid., p. 60.

9.5.3.1 Conclusion

The ACCC's view is that Telstra's arguments outlining the claimed benefits of joint pricing are not compelling. Accordingly, the ACCC's view is that it is more appropriate to determine pricing principles which allow for independent pricing of the declared services. In doing so, the ACCC does not believe that the determination of independent pricing principles is in any way likely to significantly inhibit the flexibility of Telstra and access seekers to negotiate prices where these services are purchased together.

9.6 ACCC's draft determination on pricing principles

The ACCC's draft determination is that an interim RMRC principle in the pricing of the declared services best promotes the LTIE at this point in time. Further, in implementing this principle, the ACCC considers that it is most appropriate to use:

- Avoidable retail costs, not 'avoided'
- Unbundled retail prices and
- Independent pricing of the declared services.

Accordingly, the ACCC now seeks comment on this draft determination in accordance with s. 152AQA.

Appendix A. List of submissions

Submission to discussion paper (April 2005)

AAPT	11 July 2005
Australian Communications Network	6 June 2005
Competitive Carriers' Coalition	6 June 2005
Optus	12 July 2005
Southern Phone Company	14 July 2005
Telstra	28 June 2005

Appendix B. Current LCS service description

The local carriage service is a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end user in the same standard zone.

Definitions

Where words or phrases used in this declaration are defined in the *Trade Practices Act 1974* or the *Telecommunications Act 1997*, they have the meaning given in the relevant Act.

In this Appendix:

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies;

standard zone has the same meaning as in Part 8 of the *Telecommunications Act 1997*;

telephone calls are calls for the carriage of communications at 3.1kHz bandwidth solely by means of a public switched telephone network.

Note:

If a carrier or a carriage service provider supplies "declared services" (whether to itself or to other persons), the carrier or carriage service provider is taken to be an "access provider" and the declared services are taken to be "active declared services" (section 152AR(2) of the TPA). The "standard access obligations" of access providers in relation to active declared services are set out in sections 152AR(3), 152AR(5), 152AR(6), 152AR(7) and 152AR(8) of the TPA.

An access provider must, if requested to do so by a service provider, take all reasonable steps to ensure that:

a) the technical and operational quality of the active declared service supplied to the service provider is equivalent to that which the service provider provides to itself (section 152AR(3)(b) of the TPA); and

b) the service provider receives, in relation to the active declared service supplied to the service provider, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself (section 152AR(3)(c) of the TPA).

If a service provider uses active declared services supplied by an access provider in order for it to provide carriage services and/or content services, the access provider must, if requested to do so by the service provider, give the service provider billing information in connection with the services (section 152AR(6) of the TPA). The billing information provided must comply with the Trade Practices Regulations (section 152AR(7) of the TPA).

Access providers also have other standard access obligations under section 152AR of the TPA.

The terms and conditions of access to a declared service are as agreed between an access seeker and an access provider. Failing agreement, the terms and conditions of access are as set out in an undertaking that has been accepted by the ACCC, or, as determined by the ACCC following an arbitration. In addition, model terms and conditions relating to compliance with the standard access obligations are contained in the approved TAF Access Code and may also be relevant.

Appendix C. Proposed LCS service description

The local carriage service is a service for the carriage of telephone calls from customer equipment at an end-user's premises to separately located customer equipment of an end-user in the same standard zone, except where the supply of LCS is within the same Central Business District Area of Sydney, Melbourne, Brisbane, Adelaide and Perth.

Definitions

Where words or phrases used in this declaration are defined in the *Trade Practices Act 1974* or the *Telecommunications Act 1997*, they have the meaning given in the relevant Act.

In this Appendix:

Central Business District Area in relation to a city means the exchange service areas that are classified as CBD for the purposes of the ordering and provisioning procedures set out in the Telstra Ordering and Provisioning Manual as in force on the date of effect of the renewed declaration.

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies;

standard zone has the same meaning as in Part 8 of the *Telecommunications Act 1997*;

telephone calls are calls for the carriage of communications at 3.1kHz bandwidth solely by means of a public switched telephone network.

Note:

If a carrier or a carriage service provider supplies "declared services" (whether to itself or to other persons), the carrier or carriage service provider is taken to be an "access provider" and the declared services are taken to be "active declared services" (section 152AR(2) of the TPA). The "standard access obligations" of access providers in relation to active declared services are set out in sections 152AR(3), 152AR(5), 152AR(6), 152AR(7) and 152AR(8) of the TPA.

An access provider must, if requested to do so by a service provider, take all reasonable steps to ensure that:

c) the technical and operational quality of the active declared service supplied to the service provider is equivalent to that which the service provider provides to itself (section 152AR(3)(b) of the TPA); and

d) the service provider receives, in relation to the active declared service supplied to the service provider, fault detection, handling and rectification of a technical and operational quality and timing that is equivalent to that which the access provider provides to itself (section 152AR(3)(c) of the TPA).

If a service provider uses active declared services supplied by an access provider in order for it to provide carriage services and/or content services, the access provider must, if requested to do so by the service provider, give the service provider billing information in connection with the services (section 152AR(6) of the TPA). The billing information provided must comply with the Trade Practices Regulations (section 152AR(7) of the TPA).

Access providers also have other standard access obligations under section 152AR of the TPA.

The terms and conditions of access to a declared service are as agreed between an access seeker and an access provider. Failing agreement, the terms and conditions of access are as set out in an undertaking that has been accepted by the ACCC, or, as determined by the ACCC following an arbitration. In addition, model terms and conditions relating to compliance with the standard access obligations are contained in the approved TAF Access Code and may also be relevant.

Appendix D. Proposed line rental service description

The line rental service is a line rental telephone service which allows an end-user to connect to a carrier or carriage service provider's public switched telephone network, and provides the end-user with:

(a) an ability to make and receive certain types of calls (subject to any conditions that might apply to particular types of calls). These call types may include, for example, local calls, national and international long distance calls etc

(b) a telephone number

Definitions

Where words or phrases used in this declaration are defined in the Trade Practices Act 1974 of the Telecommunications Act 1997, they have the same meaning given in the relevant Act.

In this Appendix:

public switched telephone network is a telephone network accessible by the public providing switching and transmission facilities utilising analogue and digital technologies.