Service definitions for Wholesale Line Rental and the Local Carriage Service

A NOTE PREPARED FOR MACQUARIE TELECOM ON BEHALF OF OTHER ACCESS SEEKERS

We have been asked to analyse whether the service descriptions for Wholesale Line Rental (WLR) and the Local Carriage Service (LCS) services should be altered as part of the Australian Competition and Consumer Commission's (ACCC's) review of declarations for fixed line services (ACCC 2013). The request from Macquarie Telecom, acting on behalf of itself and other access seekers, indicates that this analysis should take into account (a) the existing 'carve outs' for the supply of these services in CBD areas of certain cities in Australia and (b) the ACCC's previous decisions on exemptions for WLR and LCS services in areas outside of CBD areas.

Summary

Telstra's supply of WLR and LCS in CBD areas is generally subject to similar kinds of competitive pressures as in other non-CBD areas – in particular, there is a significant sub-set of consumers that wish to acquire voice only services that can be most efficiently supplied using existing copper lines. Consequently, we observe similar above-cost wholesale prices being charged to access seekers for these services. We find that the ACCC's analysis of the competition and efficiency effects of the supply of WLR and LCS services in non-CBD areas in 2011 is generally applicable to the supply of these services in CBD areas. It would promote the long-term interests of end-users (LTIE) for the existing exemptions for CBD areas to be removed.

Introduction and background

The history of the declaration of LCS and WLR services are summarised in Appendix D of the ACCC's Discussion Paper (ACCC 2013). The three pertinent facts are that:

- The LCS was first declared by the ACCC in 1999, and the WLR in 2007.
- The existing LCS and WLR declarations do not apply in the central business district areas of Sydney, Melbourne, Adelaide, Brisbane and Perth. This reflects an exemption previously granted for the LCS in July 2002 and extended to the WLR when it was declared in 2007.
- The ACCC also granted exemptions from the supply of WLR and LCS in certain metropolitan areas in 2008, but removed these exemption provisions in 2011.

The current service declaration for the local carriage service reads:

> 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, however, the local carriage service does not include services where the supply of the local carriage service originates from an exchange located within a Central Business District Area of Sydney, Melbourne, Brisbane, Adelaide or Perth and terminates within the standard zone which encompasses the originating exchange (ACCC 2013, 61).

A similar exemption is included in the WLR service description.

Why did the ACCC remove the exemptions for WLR and LCS services?

In 2011, the ACCC decided to revoke exemptions for WLR and LCS in certain (largely metropolitan) exchange service areas that had previously been subject to an exemption. These exemptions had been granted through regulatory and Australian Competition Tribunal processes through 2007-2010.

The ACCC's reasons for this shift were significant and (we argue) equally relevant to the ACCC's consideration of how the LCS and WLR service should be defined.

The ACCC said that:

> Having taken into account the matters in section 152BCA of the CCA, the ACCC considers that the exemption provisions should be removed…. After analysing the submissions and information provided to it, the ACCC has found clear evidence that the exemptions have not promoted competition in the exempt areas and are unlikely to do so in the future. In addition, the ACCC has concluded that the exemptions have the potential to undermine efficiency in the use of, and investment in, infrastructure.
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> In the ACCC's view, Telstra's ability to charge substantially more than the cost-based price for WLR supports a conclusion that Telstra has substantial market power in the exempt ESAs. This conclusion is further supported by evidence that Telstra is the dominant provider of wholesale voice-only services.

We submit that application of the same legislative criteria suggest that services supplied in CBD areas should also be subject to the LCS and WLR declarations

The key criteria for considering whether the exemption should be incorporated remain the LTIE criteria; in particular:

a. whether the exemptions would promote competition in the relevant markets, including both upstream wholesale and downstream retail markets, relative to a counter-factual where no exemptions are granted, and

b. whether the exemptions would promote the efficient use of, and investment in, infrastructure.

Removing the exemptions would promote competition in downstream markets

To understand the effects on competition, the ACCC usually undertakes the following conventional approach:

- first, identify the markets that are affected by the granting of exemptions,
- second, assess the state of competition within those markets, and
- third, assess whether price and service offerings to consumers in those markets have improved, or are likely to improve, as a result of the exemptions compared to the situation without the exemptions—the 'future with and without' assessment.

Below we briefly discuss the relevant effects of regulated supply of WLR and LCS on competition.

The relevant retail and wholesale markets are limited to voice services

Access seekers use WLR and LCS services to offer voice services, and bundles of data and voice services. WLR services are also sometimes acquired to facilitate other means of communication (fax machines) or other services (e.g. alarms).

As we discussed in our 2011 report on WLR and LCS exemptions (Frontier Economics 2011), to define the relevant markets, we must first consider the question of the purpose of the market definition. For the purposes of considering the exemptions, we are particularly interested in understanding Telstra's market power in the supply of wholesale inputs into fixed voice calls, and its market power in the retail market in which voice calls are supplied.

A key issue is whether there is a distinct market for the retail supply of voice (only) services. It is evident that there are a large number of customers that demand voice services (in particular, access services) in exempt CBD areas. The ACCC's CAN snapshot from March 2013 (ACCC 2013) suggests there are over 157,000 SIOs in Band 1 areas (which we understand to be synonymous with CBD areas (ACCC 2009)), which would include a significant number of WLR SIOs. Commonly, these customers are not large enough to demand 'high end' fibre voice solutions (including VoIP) and often acquire their data services separately. To service these customers, access seekers are almost entirely reliant on Telstra to supply wholesale inputs.

Consequently, we find that it is important to consider the impact of exemptions on competition in:

- Retail markets for supply of voice only services

- Wholesale markets for the supply of voice only services in CBD areas (which included self supply of these services by owners of fibre networks)

Competition in the wholesale market is ineffective

The argument for competitive supply of WLR and LCS services (including self supply) rests on Telstra being constrained by competing suppliers of these services. Such constraints do not, however, exist for a significant sub-set of customers; those interested in acquiring voice only retail services.

As we identified in our 2011 report, the key point is that competition introduced by access seekers using ULLS as an input, or by fibre providers using their own networks, has not benefited all consumers in the fixed voice market. There is not a sufficient incentive for ULLS-based access seekers or fibre networks to supply *voice-only* services – whether at the retail level, or to other access seekers via wholesale equivalents to WLR/LCS/PSTN OA. Regulation of the ULLS and installation of fibre networks have only benefited those consumers that are willing to take a bundle of data and fixed voice services. Consumers that wish to purchase voice only services remain dependent on Telstra and access seekers that acquire WLR, LCS and PSTN OA services.

The competitive factors are reflected in both structural and performance market indicators, which collectively suggest that competition is not effective in the wholesale markets in which LCS and WLR are supplied. The structural indicators are that:

- first, Telstra has a very high direct wholesale market share and faces little to no direct constraint on its pricing of WLR and LCS
- second, there are material barriers to entry, as to install equipment to only deliver voice services is costly and uneconomic given the likely number of users of such a service.

The structural indicators are suggestive of limited competition and this is supported by the key performance indicator – prices. Many access seekers currently pay Telstra $31.77 per month for the WLR service in exempt CBD areas, while at the same time paying Telstra $22.84 per month for the WLR service in regulated areas. That is, the CBD exemption actually costs access seekers $8.93 per month for each of the WLR services it acquires in CBD areas. The magnitude of this overcharge in total across all seekers is significant – upwards of $4 million per year assuming a similar number of ULLS and WLR SIOs in CBD areas.[1]

1 We also note that the true efficiency costs of this are greater as even the average cost of WLR services *in Band 1 areas* is much lower than the average cost *across all four bands* – which is the basis on the which the WLR price of $22.84 is set.

This evidence is at odds with the ACCC's expectation expressed in 2002 that alternative infrastructure would act as a constraint on the LCS price, and reinforced in its 2006 decision to exempt WLR services from supply in CBD areas:

> The Commission is of the view that there is sufficient alternative infrastructure (such as fibre loops) and declared services (local PSTN originating access and ULLS) for originating local calls in CBD areas either being used or can readily be used by alternative carriers and carriage service providers. The presence of such alternative infrastructure and services is believed to be adequate to serve as substitutes to the Local Carriage Service and act as a constraint on the Local Carriage Service price that Telstra would be able to charge in the absence of the Commission's power to determine a Local Carriage Service price upon the granting of an exemption. (ACCC 2002)

As we noted in our 2011 report, there has been no credible explanation for the higher prices of WLR services in areas where Telstra had been exempted from regulation, and how this could be consistent with the competitive constraints that might be thought to exist.

Declaration would promote competition in retail markets

While there are currently a number of competitors to Telstra in the market, we have been informed by Macquarie Telecom they are nearly all heavily reliant on Telstra for wholesale inputs. There is no functioning wholesale market for WLR and LCS services.

Declaration would be likely to promote resale competition between Telstra and access seekers in retail markets. Compared to the counter-factual of the exemptions continuing, access seekers would be disadvantaged, as when they put together retail services for users with requirements for a small number of fixed lines, they must offer prices that are below cost to compete with Telstra (which sells retail lines at similar or lower prices as the wholesale prices[2]), or risk being uncompetitive.

Further, there is little prospect of declaration deterring infrastructure-based competition. As was noted in our 2011 report, there was little – if any – ULLS-based entry to supply voice services only, and to connect buildings with new fibre services to merely supply voice services is also uneconomic.

2 Imputed margins for access and local services are negative for both business and residential users, see for example (ACCC July 2012, 13)

Removing the exemption in CBD areas would increase the efficient of use of infrastructure, and not deter efficient investment

Efficiency in the use of infrastructure is promoted by prices that are closer to marginal cost. Extending the declaration would have the immediate impact of lowering the prices for wholesale WLR and LCS services to a level that recovers *average* cost (which is greater than marginal cost) as measured using the ACCC's fixed line services model. This will ultimately feed through to lower retail prices for fixed voice services, and improve the use of infrastructure and allocative efficiency.

Further, we see little risk of the exemption removal creating a risk of inefficient investment or, conversely, a reduction in efficient investment. Existing infrastructure owners in CBD areas will be keen to fully exploit their networks rather than revert to relying on WLR and LCS where they have already entered and incurred sunk costs, and could be expected to do so where this is efficient (i.e. the revenue from connecting a new customer exceeds costs incurred).

In summary, resale competition appears to be a viable and productive use of scarce resources in CBD areas, and this will depend on continuing and effective access to WLR and LCS services.

References

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