



# **Geographic exemptions for WLR, LCS and PSTN OA services**

**A REPORT PREPARED FOR MACQUARIE TELECOM**

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# 1 Introduction and overview

The ACCC has recently issued draft Final Access Determinations (FADs) for declared fixed line services.<sup>1</sup> In these FADs, the ACCC has proposed to exempt Telstra from supplying WLR, LCS and PSTN OA in certain local exchanges. The ACCC is proposing to effectively ‘roll over’ the existing exemptions that were introduced for these services under the previous Part XIC arrangements.

Macquarie Telecom has asked Frontier whether this proposal accords with the legislative criteria that the ACCC must take into account under Section 152BCA of the *Competition and Consumer Act 2011*. These criteria include (but are not limited to):

- the long-term interests of end-users (LTIE)
- the legitimate business interests of Telstra (or other provider)
- the interests of all persons who have rights to use the declared service
- any other relevant matters.

Our view is that the ACCC should not incorporate the effect of the previously-granted exemptions in the FADs.

We have particular concerns that the exemptions will diminish competition in markets for fixed voice services, and prevent the efficient use of infrastructure by which fixed voice services are supplied. Further, granting the exemptions would seem highly unlikely to encourage more efficient investment in infrastructure. Accordingly, we do not consider that incorporating the exemptions into the FADs meets the critical test of being in the LTIE; and nor would consideration of the wider set of criteria under Section 152BCA alter this view.

In the following sections of this report, we explain this conclusion as follows:

- Section 2 outlines the framework to analyse if exemptions should be granted, including the relevant background to the consideration of exemptions for WLR, LCS and PSTN OA services
- Section 3 specifies the relevant markets and the state of competition in these markets
- Section 4 details why granting the exemptions would not promote competition
- Section 5 details why granting the exemptions would not promote efficient use of, and efficient investment in, infrastructure.

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<sup>1</sup> ACCC, *Public inquiry to make final access determinations for the declared fixed line services: Discussion paper*, April 2011 (Discussion paper)

## 2 Background and the analytical framework for considering the exemptions

### 2.1 The ACCC's 2008 exemption orders

In 2008, the ACCC made an exemption order for the LCS and WLR (and subsequently PSTN OA) in response to an application from Telstra. For the purpose of assessing the exemption against the applicable legislative criteria, the ACCC identified the relevant markets as those for fixed voice and combined fixed voice and broadband services. The ACCC concluded that granting the exemptions would promote competition, and it made the following comment in relation to the fixed voice market:

In considering whether the granting of exemptions will promote competition, a key issue for the ACCC's assessment is the extent to which access seekers can compete in the downstream market for fixed voice services via use of the ULLS in the absence of regulated access to the LCS and WLR. Increased ULLS-based provision of voice services will be in the LTIE as it will enable competitors to compete in the downstream market on greater dimensions of supply and allow them to dynamically innovate their services, leading to more sustainable competition compared with pure re-sale models in the longer-term. Increased ULLS-based competition will also stimulate the provision of LCS and WLR from ULLS-based competitors seeking to exploit unused capacity, or to exploit potential economies of scale, on their ULLS-based networks. This will provide increased competitive tension at the wholesale level and constrain Telstra's ability to price its LCS and WLR services at supra-competitive levels in ESAs in respect of which exemption is granted.<sup>2</sup>

In deciding whether to incorporate the exemptions into the FADs, the ACCC is now in a position to consider whether the postulated outcomes are actually occurring. We will present evidence below to show that they are not.

A second relevant consideration that was relevant to the ACCC's initial decision was that the NBN was then a much different and less certain reality than it is now. This change in circumstances will need to be reflected in the ACCC's decision whether to incorporate the exemptions.

### 2.2 The Tribunal's 2009 *Chime* decision

The exemption decisions of the ACCC for the three wholesale access services were remade (with a number of differences) by the Tribunal during 2009. This followed an appeal of the ACCC's exemptions orders by access seekers.

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<sup>2</sup> ACCC, *Telstra's local carriage service and wholesale line rental exemption applications – Final Decision and Class Exemption*, August 2008, p. 6.

In considering whether granting the exemptions would promote competition, the Tribunal stated that exemptions would only promote competition under certain conditions:

In the Tribunal's view, it is also necessary by an appropriate condition to ensure that immediately prior to deregulation (the denial of regulated access to WLR/LCS): (a) there are a sufficient number of access seekers who can supply services through the ULLS to provide a competitive restraint on the incumbent (Telstra) in its supply of services, including the supply of WLR/LCS; and (b) their position in the market (ie in each nominated ESA) is sufficiently consolidated so that it is likely that if deregulation is ordered, the entrants will undertake the necessary investment, so that ULLS-based supply will constrain the actions of Telstra.<sup>3</sup>

As we have observed above, we are now in a better position to consider whether these conditions have materialised and had the effects that the Tribunal expected. The following statement made by the Tribunal in the context of applying the statutory criteria to expectations about the future is also pertinent here:

...while past events are not a certain guide to the future, their evaluation is a necessary, if not integral, step in determining what is likely to happen in the future...<sup>4</sup>

We also consider it important to note that the Tribunal was specifically restricted to consider only information that was available to the ACCC at the time of making its decision (due to the former s 152AW(4) of the *Trade Practices Act 1974*). Critically, the Tribunal was not permitted to include consideration of the Government's new FTTP NBN proposal (as opposed to the earlier FTTN NBN proposal) that was made after the ACCC's decision.<sup>5</sup> This proposal has progressed significantly since then, with relevant legislation passed and the rollout commencing, although there remains uncertainty about the timetable for rollout in specific areas.

## 2.3 The analytical framework for considering the exemptions

The ACCC has outlined its view of the relevant legal framework for considering whether to include the exemptions into the FADs in its Discussion Paper:

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<sup>3</sup> Australian Competition Tribunal, Application by Chime Communications Pty Ltd (No. 2) [2009], para 157.

<sup>4</sup> Australian Competition Tribunal, Application by Chime Communications Pty Ltd (No. 2) [2009], para 13.

<sup>5</sup> Australian Competition Tribunal, Application by Chime Communications Pty Ltd (No. 2) [2009], para 126.

When making an FAD and deciding whether or not the effect of the Exemption Determinations should be incorporated into an FAD, the ACCC must have regard to criteria in subsection 152BCA(1) of the CCA, which includes the LTIE. The ACCC may also consider any other matters that it thinks are relevant, such as regulatory certainty and consistency. (p. 218)

Although similar to the framework under which the exemptions were considered by the ACCC and the Tribunal, there are additional criteria in section 152BCA, including an ability to consider other relevant factors. Of particular significance, the ACCC a number of times refers to ‘regulatory consistency’ as a reason for rolling over the exemptions.

We accept that regulatory consistency is an important precept. However, we consider it is most relevant where industry circumstances remain the same, or broadly similar. Disruptive changes to industry conditions requires regulation that is responsive to these changing circumstances. The passage of legislation to roll out the NBN is one such change, and regulation must reflect the influence this paradigm shifting investment will have on all of the industry.

Our view is that the key criteria for considering whether the exemption should be incorporated remain the LTIE criteria; in particular:

- (i) 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
- (ii) whether the exemptions would promote the efficient use of, and investment in, infrastructure.

We now turn to our assessment of these issues.

## 3 The relevant markets and the state of competition in these markets

### 3.1 The relevant markets

Markets are defined to aid the analysis of competition and market power. They should be defined in a way that helps us analyse the competition or market power issue at hand: to quote Maureen Brunt:

As is often said, the market concept is an instrumental concept, designed to assist in the analysis of processes of competition and sources of market power.<sup>6</sup>

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. It seems common ground that the scope of the relevant retail and wholesale markets are no narrower than the bundle of fixed voice services, consisting of line rental and calls (or call inputs). This follows from the ACCC's original exemption determination<sup>7</sup>, and from the Tribunal, which said:

Speaking generally, the relevant product or service markets in which one would ordinarily determine the effect of the exemptions in the future with and the future without scenarios are: (a) the downstream (retail) markets for the supply of all fixed voice services; (b) the upstream (wholesale) markets for the supply of wholesale inputs into the retail supply of fixed voice services, including the WLR service, LCS and ULLS; (c) the upstream (wholesale) markets for the supply of bundled broadband and voice services; and (d) the downstream (retail) markets for the supply of bundled broadband and voice services.<sup>8</sup>

The ACCC has adopted these definitions in its Discussion Paper.

It is an odd feature of both the ACCC and Tribunal's approach that there is a clear overlap in the defined markets. That is, the fixed voice market is a subset of the 'bundled' fixed voice and broadband market. Although this market characterisation may have helped put ULLS-based competition into context (because ULLS is not solely used to provide voice services), it is apparent that

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<sup>6</sup> Brunt, M., "Market Definition Issues in Australian and New Zealand Trade Practices Litigation", *Australian Law Business Review*, 1990, Vol. 18, p. 193.

<sup>7</sup> ACCC, *Telstra's local carriage service and wholesale line rental exemption applications Final Decision and Class Exemption*, August 2008

<sup>8</sup> Australian Competition Tribunal, Application by Chime Communications Pty Ltd (No. 2) [2009], para 108.



this focus has been unhelpful in relation to the correct analysis of competition for *voice-only* customers.

The approach taken to market definition has led to a fallacy in the ACCC's (and the Tribunal's) analysis of competition: that competition introduced by those access seekers using ULLS as an input, has, or will, benefit all consumers in the fixed voice market. However, this implicitly relies on there being sufficient incentive for ULLS-based access seekers to supply *voice-only* services – whether at the retail level, or to other access seekers via wholesale equivalents to WLR/LCS/PSTN OA. Further analysis (which we discuss in more detail below) reveals that ULLS has *only* benefitted those consumers that are willing to take a bundle of ADSL 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.

In summary, competition for customers that only wish to buy fixed voice services (and perhaps wish to buy data services separately) appears to be quite different than for those customers that are willing to buy a bundle of voice and data services. The ACCC's market analysis has served to confuse rather than to bring out this point.

### 3.2 The state of competition in the relevant fixed voice markets

The ACCC analyses the state of competition as a pre-cursor to considering whether the exemptions would promote competition. Competition in the 'factual' world with the existence of the exemptions can then be compared with a 'counterfactual' where the exemptions are not incorporated into the FADs.

The ACCC considers the relevant wholesale markets are those in which 'resale' and 'access based' supply of fixed voice services occurs – thereby including self supply of ULLS-based WLR, LCS and PSTN OA equivalents.

As we indicate above, this market definition is not helpful in understanding the different competitive constraints on firms that supply wholesale services. Rather, in considering the exemptions, we think it is more helpful to consider competition in retail markets for (a) voice only services<sup>9</sup> and (b) bundles of voice and data services. The equivalent wholesale markets are for inputs to voice only services, and inputs into bundles of voice and data services.

With respect to the first kind of market – voice only services – we observe that Telstra has a particularly strong grip on both the retail and wholesale market.

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<sup>9</sup> The gap in the ACCC's analysis seems to be reflected on p. 230 of its Discussion Paper where it does not mention the supply of wholesale services as being relevant to the consideration of the competitiveness of the retail market for fixed voice services.

Competition in markets for bundled voice and broadband services is more vigorous, so we focus our attention here on voice only markets.

### 3.2.1 Competition in the retail voice only market

Although many customers now acquire bundles of voice and data services, there are still a significant proportion of residential and business end-users that acquire voice only services. Telstra's latest CAN RKR indicates that 60% of Band 2 lines are still voice only (at 31 December 2010). Extrapolating this percentage to the estimated number of lines in the 181 currently exempt Band 2 ESAs<sup>10</sup>, we estimate that around 1.25 million lines are still 'voice only' in the exempt areas. We estimate that Telstra has around a 73% retail share of these lines based on its share in the 380 'Attachment A' ESAs.<sup>11</sup>

While there are currently a number of competitors to Telstra in this market, they are nearly all heavily reliant on Telstra for wholesale inputs, and there are few, if any, voice only customers using ULLS as an input.<sup>12</sup> Where this does occur, we understand that it is dependent on more than 4 retail lines being taken.<sup>13</sup> We also understand that Optus also has very few voice only customers on its HFC network.

### 3.2.2 Competition in the wholesale voice only market

Demand in this market is derived from retail demand. This market therefore includes Telstra's supply of WLR, LCS and PSTN OA, and the very limited self-supply by Optus using its HFC network and self-supply by ULLS-based access seekers.

Optus and ULLS-based access seekers have not been actively supplying wholesale services to access seekers. Any competitive constraint they apply to Telstra in the wholesale market would therefore operate indirectly, via the retail market. That is, Telstra's ability to push up wholesale prices for voice services is only subject to the quite weak constraint offered by switching by retail voice only

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<sup>10</sup> We estimate the number of voice only lines in the 181 exempt ESAs by expressing these ESAs as a percentage of total number of Band 2 ESAs of 583 from Telstra's TEA model (i.e. 31%) and multiplying this by total Band 2 voice only lines. The TEA model figure is reported in Telstra, *Efficient Access (TEA) Model Overview*, December 2007, <http://www.accc.gov.au/content/item.phtml?itemId=830328&nodeId=a1387e8093be54b65626adf8aec4bbc7&fn=4%20-%20TEA%20Model%20Overview.pdf>

<sup>11</sup> ACCC discussion paper April 2011.

<sup>12</sup> We note also that in addition many access seekers will still be reliant on Telstra WLR if they supply the voice service to a customer who is supplied broadband via wholesale ADSL or LSS.

<sup>13</sup> This is supported by the ACCC's imputation reports for Telstra, see Section 4.1.1.

customers to Optus and other ULLS-access seekers.<sup>14</sup> Telstra's wholesale market share subsequently approaches near monopoly levels.

However, in thinking about the state of competition in this market, we also need to consider:

- the barriers to entry for Optus or existing ULLS-based suppliers of retail voice and data bundles
- the barriers to entry for access seekers that currently acquire WLR, LCS and PSTN OA from Telstra.

Why Optus and ULLS suppliers are not particularly interested in supplying wholesale services to third parties is a matter of debate. It may be for a number of reasons: Ofcom's market analysis for wholesale analogue line rental services found that:

“3.30 In the absence of wholesale regulation, it is unlikely that a hypothetical monopolist would provide an analogue wholesale line rental product as this enables other providers to offer retail narrowband access services in direct competition with its own retail operations.”<sup>15</sup>

Alternatively, it may be that these ULLS-based suppliers view the sale of wholesale services as a distraction to their core business of selling to retail customers. For example, selling wholesale services would require investments in ordering and billing systems, customer management, fault repair, and other wholesaling activities. Other ULLS entrants have chosen entry models that are simply not suited to wholesale supply. We are advised, for example, that [c-i-c]

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<sup>14</sup> This constraint is obviously stronger for those customers that are interested in acquiring a bundle of voice and data services.

<sup>15</sup> Ofcom also argues that ULLS-based entrants have not and will not substantially undermine BT's market power in the market for wholesale fixed analogue lines, because their growth is limited to customers who are willing to bundle voice with broadband. It states that:

“In the last five years LLU (MPF) based wholesale fixed analogue exchange lines have grown significantly, from a zero base to 11% of the wholesale market. In particular, these services have increased their share by 5% in the last year. Whilst we expect to see further growth in these services we do not believe that they are likely to significantly undermine BT's SMP in this market over the next three and a half years. This is because most of the LLU (MPF) growth is attributed to TTG growing its customer base for voice and broadband services, and more recently Sky up-selling its existing broadband customers to voice and broadband. The current growth rate is therefore not sustainable. Rather, the maximum volume of LLU (MPF) based wholesale fixed analogue exchange lines is likely to be limited by the number of LLU based broadband customers. The growth rate of LLU based broadband, whilst positive, is much slower than the recently seen growth rate in LLU (MPF) based wholesale fixed analogue exchange lines. Further, even if all the current LLU based broadband customers were to convert to LLU (MPF) based voice and broadband this would only change the current wholesale fixed analogue exchange lines market shares by about 12%. LLU would go up to about 23% and BT's share would come down to about 61%. Therefore, we do not believe that LLU will significantly affect the existence of SMP in the wholesale fixed analogue exchange line market over the next three and a half years.”

does not operate a PSTN network for voice services and has no intention of establishing one.

In analysing competition in the wholesale market, we also need to consider whether those access seekers who could not source the wholesale inputs from Telstra (at prices that would enable competition with Telstra in the downstream market) could enter the market directly. However, there are material barriers to entering the voice only market. We discuss these barriers in the following section of this report, but in summary they include scale economies (minimum efficient scale) and commercial uncertainty caused by the NBN rollout.

In summary, Telstra has a very high (near monopoly) market share in the wholesale market and faces little to no direct constraint on its pricing of WLR, LCS and PSTN OA. Combined with barriers to entry, this means it has significant market power and will be able to exercise it in the wholesale voice market to favour its retail operation. This conclusion about the state of competition in the wholesale market is reinforced by evidence on market performance: Telstra is (i) demonstrating that it can increase wholesale voice prices without attracting entry and (ii) can maintain discriminatory prices for business and residential users in exempt areas – even though in non-exempt areas the ACCC has set a flat rate for WLR, reflecting that there is no difference in the cost of supply of these services. In turn, we can expect this market power will directly influence downstream prices and competition for services in fixed voice markets.

## 4 The proposed geographic exemptions would not promote competition in the fixed voice market

The ACCC's supposition is that if the exemptions are granted, Macquarie and others buyers of WLR, LCS and PSTN OA services could still compete effectively in the retail market with Telstra to provide voice only services. Indeed, the ACCC must consider that granting the exemptions would positively improve the conditions for competition in that market. As we identify above, these carriers would need to enter the market using ULLS or other infrastructure, or otherwise obtain access to equivalent WLR/LCS services that would promote competition in the wholesale and retail markets for the supply of voice services that is otherwise not there. The evidence does not support this supposition. Instead, a lessening of competition with the continuation of the exemptions seems more likely.

### 4.1 Wholesale and retail entry into the voice market is unlikely

The ACCC has placed a high weight on the use of exemptions to encourage a certain form of competition – moving access seekers “up the ladder”. The theory is that removal of access to WLR and LCS will encourage ‘deeper’ ULLS-based competition to provide voice and bundled voice and broadband services.

As we point out in Section 3, while greater use of ULLS enhances competition for the supply of broadband and the bundle of voice and broadband (leaving aside the impact of the NBN), the evidence we have examined suggests it is implausible that entry using ULLS will occur just to service fixed voice markets. This is for three main reasons:

- new entry is uneconomic, given the scale of existing entry and customer distribution in the existing exemption areas
- suppliers of services using ULLS will not find it economic to supply wholesale or retail voice only services
- the NBN creates a substantial risk that new investments will become stranded before capital costs and a reasonable return on capital have been recovered.

#### 4.1.1 Entry is not feasible or likely

In this section, we provide further evidence of why ULLS-based entry to provide wholesale and retail voice services is not viable.

**Final**      **The proposed geographic exemptions would not promote competition in the fixed voice market**

As a starting point, we wish to point out that the ACCC's statements about the viability of new entry seem contradictory, and in conflict with the Tribunal's analysis. In the Discussion Paper, the ACCC states that:

Based on the most recent information before it, the ACCC considers that the **average payback period on previous DSLAM investments** (i.e., typically within the 380 Attachment A ESAs) for an efficient competitor is approximately **two years**.<sup>16</sup>

But says earlier in the Discussion Paper that:

The ACCC has previously accepted that an efficient access seeker is likely to **make a return on a DSLAM investment within two years** of deployment, and considers that this is likely to remain the case.<sup>17</sup>

Although the ACCC does not further explain these statements, it is apparent that these concepts are quite different. The ACCC's suggestion of a two year payback seems to be a mistaken interpretation of what the Tribunal said.

The Tribunal's analysis suggested that the while returns on investment might be earned within two years, 'payback' would require five years or longer:

The precise cost of purchasing and installing DSLAM equipment and carrying out associated works is not clear. Dependent upon the configuration of the equipment (eg voice and broadband and number of services to be provided), the cost estimates (eg equipment, installation and other associated costs) range from \$11,500 to \$51,000. Nonetheless there is material which suggests that **an entrant could make a return on its investment within two years and recover its outlay within five years**.<sup>18</sup>

Although this statement could be interpreted in different ways, it seems that the Tribunal is arguing that operating costs could be recovered within two years (and that some contribution to capital cost recovery would be made) but that full recovery of capital cost outlays would take much longer.<sup>19</sup>

Moreover, the Tribunal's assessment will now be less likely to hold given that:

- it must be more difficult to make a return now given there are more competitors in each ESA and voice traffic volumes per line are likely to be lower than originally projected. Looking back at past returns is quite different from looking at future returns for a new entrant. Any analysis of margins and payback must be forward-looking.

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<sup>16</sup> ACCC Discussion Paper, April 2011, p. 238 (emphasis added).

<sup>17</sup> ACCC Discussion Paper, April 2011, p. 234 (emphasis added).

<sup>18</sup> Australian Competition Tribunal, Application by Chime Communications Pty Ltd (No. 2) [2009], para 143 (emphasis added).

<sup>19</sup> It is also unclear whether 'recovering its outlay' would include earning a commercial return on investment. If it does not, returns will need to be made for more than five years.

- there is a significant risk that the payback period will never be reached because the copper in the ESA is decommissioned due to the rollout of fibre by NBN Co
- conditions imposed by the Tribunal raise the risk that an exchange may become non-exempt as a result of competitive entry if it leads to exchange capping or a fall in WLR SIOs – thereby undermining the commercial case for entry.

The ACCC's conclusions about the prospect of entry can be contrasted with those of Ofcom, which found that '[t]he number of LLU operators that can achieve the required scale will be inherently limited.'<sup>20</sup> It therefore found an ongoing need to subject wholesale fixed voice inputs to ongoing access regulation.

In 2007, Frontier analysed the minimum efficient scale for access seekers supplying bundled voice and ADSL services. We concluded that it was around [c-i-c] subscribers per exchange. This was based on available monthly revenues of \$102, based on Telstra's imputation testing reports. However, current average voice revenues are only just over half of this amount, and (assuming many costs are fixed) this would significantly reduce the ability of access seekers to recover investment costs.<sup>21</sup>

### **ACCC ULLS imputation reports**

The ACCC's own reports on Telstra's profitability are evidence that voice only entry using the ULLS is highly unlikely. The imputation testing reports<sup>22</sup> test whether an access seeker as efficient as Telstra in the transformation of the ULLS into retail services could profitably provide retail voice, broadband (ADSL) and a bundle of ADSL and voice services. The December quarter 2010 report shows large negative margins for the use of ULLS for ADSL and the supply of the bundle of residential voice and ADSL services. It is also possible to calculate the margin for the use of ULLS for the provision of voice services from the data provided, which also indicates a significant negative margin (-15%).<sup>23</sup>

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<sup>20</sup> Ofcom, *Review of the wholesale fixed analogue exchange lines markets*, Consultation, 15 October 2010, 4.8(ii), <http://stakeholders.ofcom.org.uk/binaries/consultations/review-wholesale-fixed-exchange/summary/main.pdf>

<sup>21</sup> Frontier Economics, *Telstra's applications for WLR and LCS exemptions – A report prepared for the Competitive Carriers Coalition, Confidential Version*, October 2007, p. 17.

<sup>22</sup> See e.g. ACCC, *Imputation and non-price terms and conditions report relating to the accounting separation of Telstra for the December quarter 2010*, March, 2011

<sup>23</sup> ACCC, *Imputation and non-price terms and conditions report relating to the accounting separation of Telstra for the December quarter 2010*, March, 2011, p. 1, Table 2.3.

For business services, the margins shown are better, and, in the case of voice only lines, positive. However, this result is crucially dependent on the assumption that 4 voice services are supplied over a single ULLS line and each is charged as a separate retail line. The margins are shown in Table 1 below.

Table 1: Margins on supply of retail services using ULLS, December quarter 2010

Retail services	Residential	Business (4 voice lines acquired)
ADSL and voice	-18%	18%
Voice only*	-15%	26%

Notes:

\* Frontier Economics calculation from ACCC data

Source: ACCC and Frontier Economics

A key issue raised here is how many businesses are likely to require 4 voice lines. Our analysis indicates that a large number of businesses do require 4 voice lines. We are advised by Macquarie Telecom that for many businesses there is between a 1 to 2 ratio between the number of employees and the number of voice lines purchased (i.e. between 1 to 2 employees per voice line purchased). ABS data indicates that out of around 2 million businesses in Australia over half (1.23 million) have no employees (i.e. owner operated only)<sup>24</sup> so would likely only require one voice line. In such a case, the ACCC's imputation data indicates a margin for voice supplied over ULLS of only 3%, but based on Telstra's costs and the assumption that these businesses pay business and not residential line rental.<sup>25</sup> We are advised also that many larger businesses for which it is more economical to purchase ISDN lines will also retain 1 or 2 voice lines for EFTPOS, fax, alarm monitoring purposes, so these lines would also have relatively low margins.

We note also that if access seekers are less efficient than Telstra in transforming the ULLS (say due to only having a small number of customers per exchange or lack of scale economies in other costs) the margins would be lower.

#### 4.1.2 New entry is made much riskier by the NBN

New entry into the wholesale market for voice services is much less likely now than it was when the ACCC first considered the exemptions in 2008. Since that

<sup>24</sup> ABS, *Counts of Australian Businesses, including Entries and Exits, Jun 2007 to Jun 2009*, Cat. No. 8165.0, <http://www.abs.gov.au/AUSSTATS/abs@.nsf/DetailsPage/8165.0Jun%202007%20to%20Jun%202009?OpenDocument>

<sup>25</sup> The ABS business statistics also indicate that there are around 500,000 businesses that have between 1 and 4 employees and 234,000 with between 5-19 employees, indicating the ACCC's assumption of 4 lines per business customer applies perhaps to only around 30% of businesses.



time, the Government has committed funds, set up a company and passed the legislation necessary to commence construction and commercial operation of an NBN.

The ACCC's reasoning in its April 2011 Discussion Paper that the NBN will not affect infrastructure deployment is partially based on its flawed assessment that entrants can recover their investment in 2 years (rather than 5, which appears the more realistic estimate). It states:

The ACCC considers that the extent to which DSLAM/MSAN assets could be stranded by the NBN depends, in a large part, upon details of the implementation of the NBN by NBN Co, such as notice periods for cutover from copper to fibre. Based on the most recent information before it, the ACCC considers that the average payback period on previous DSLAM investments (i.e., typically within the 380 Attachment A ESAs) for an efficient competitor is approximately two years.<sup>26</sup>

Further to this, it goes on to say that:

The construction of the NBN is likely to be completed by 2020...If the fibre roll-out will not affect an ESA until the later stages of the NBN roll-out, the NBN will not be likely to impact significantly upon the ability of an efficient access seeker to recoup DSLAM investments in the 380 Attachment A ESAs.<sup>27</sup>

This entirely speculative statement then becomes one of the reasons why the ACCC is inclined to include the exemptions in the FADs. We see no basis for concluding that the NBN Co could not roll out fibre within the exempt exchange locations within the next 5 years. At the very least, this possibility will substantially increase the risk associated with investments in copper-based services. Although we lack knowledge about the key elements of when and where NBN Co will commence its rollout, as this is partially contingent on a deal with Telstra being finalised, we do know that full-blown construction of the NBN is expected to be underway from 2012.<sup>28</sup>

### 4.1.3 There is little prospect of an active wholesale market

The ACCC's support for the original exemptions was based on the prediction that there would be alternative suppliers of a WLR, LCS and PSTN OA using ULLS. These suppliers would serve to constrain Telstra from raising prices for these services:

Further, the ACCC notes that increased ULLS-based competition will likely stimulate the provision of wholesale voice services from ULLS-based

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<sup>26</sup> ACCC Discussion Paper, April 2010, p. 238.

<sup>27</sup> ACCC Discussion Paper, April 2010, p. 238.

<sup>28</sup> See Mike Quigley presentation to Commsday Summit, March 2011, slides 4-5, <http://www.nbnco.com.au/wps/wcm/connect/downloads/announcement/NBN%20Co%20-%20Commsday%20Summit%2029%20March%202011.pdf>

competitors seeking to exploit unused capacity on their ULLS-based networks. This will provide increased competitive tension at the wholesale level and likely constrain Telstra's ability to price its LCS and WLR services at supra-competitive levels were the Exemption Applications to be granted.<sup>29</sup>

This reasoning has been replicated in the draft FADs discussion paper:

Therefore, in the majority of ESAs, competitively priced alternative WLR/LCS-type services are likely to be available in the event of a price rise by Telstra (the ULLS continues to be a regulated service in those ESAs).<sup>30</sup>

Now, however, there is a range of evidence to the contrary to show that this reasoning was – and is – implausible. This evidence includes the following:

- [c-i-c]

With no new entry likely, wholesale markets take on an increased level of importance for competition. This does not seem to have been reflected in the ACCC's thinking.

#### 4.1.4 Regulation in the wholesale market would promote competition

We also note that, by way of comparison, this would follow other decisions made by the ACCC in recent times which have taken greater account of the implications of competition in wholesale markets on performance in downstream retail markets.

The approach taken by the ACCC in its merger decision on the proposed acquisition of Franklins' stores by Metcash was to emphasise that indirect constraints (deriving from the retail level) might not constrain decisions made at the wholesale level if there were barriers preventing competition at the wholesale level. The ACCC found that:

The ACCC's investigation has also indicated that although the large supermarket chains impose a competitive constraint on IGA and Franklins stores at the retail level, this provides only an indirect and imperfect competitive constraint on Metcash at the wholesale level. The important additional competitive constraint that comes from direct competition at the wholesale level from Franklins would be lost as a result of the proposed acquisition. That competition presently forces Metcash to compete on wholesale prices, rebates, promotions and services to independents.

Here, the ACCC is saying that the loss of *wholesale* competition would adversely affect retailers who compete with the vertically-integrated Coles and Woolworths in retail markets; yet, it seems to find in relation to the exemptions that the

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<sup>29</sup> ACCC, 2008, p. 117.

<sup>30</sup> ACCC, discussion paper, p. 237

absence of alternative wholesale supply would not affect competition in retail markets.

**Final**      The proposed geographic exemptions would not promote competition in the fixed voice market

## 5 The exemptions would not promote the efficient use of, or investment in, infrastructure

The ACCC and the Tribunal largely appeared to tie the competition and efficiency questions together in the exemption process: if granting the exemptions will promote competition, they will also promote efficiency. Therefore, it seems that the main question here is whether overturning the exemptions would discourage further investment at local exchanges, thus denying consumers the benefits of quasi-infrastructure competition. The ACCC essentially repeats its arguments that the exemptions will promote efficient investment in DSLAMs ‘where it is efficient for them to do so’.

It will be obvious from the preceding sections of this report that we have reached a different conclusion about whether granting the exemptions will promote competition. So, accepting the premise of the ACCC and the Tribunal here, we reach a different conclusion about the promotion of efficiency.

We consider that the likely outcome of granting the exemptions will be:

- No new investment – efficient or otherwise – to provide voice services. The case to invest in voice only infrastructure is limited and will not be improved by incorporating the exemptions.
- Higher prices for wholesale WLR, LCS and PSTN OA services, which will ultimately feed through to retail prices for fixed voice services, and harm allocative efficiency.
- There will be little effect in markets for bundled fixed voice and broadband services, because existing ULLS-based entrants will be keen to fully exploit their voice networks rather than revert to:
  - relying on WLR, LCS and PSTN OA where they have already entered an ESA or
  - entering new ESAs using wholesale voice services and LSS.

### 5.1 Is promoting new investment efficient?

The ACCC does not consider whether new entry would be economically wasteful in its analysis of efficient investment. The dominant ‘infrastructure based’ paradigm that has influenced the ACCC’s thinking over the past 10 years – with which we take no issue – does appear to be becoming less relevant with the emergence of the NBN.

With that in mind, we are somewhat puzzled by the ACCC’s reference to its 2008 statement that: “Overall, the ACCC’s view is that ULLS-based competition is a

**Final**            **The exemptions would not promote the efficient use of, or investment in, infrastructure**

preferable form of competition to re-sale based competition in the long-term.” (p. 238) The ACCC quotes this statement and reinforces its continued applicability.

This statement may have been reasonable to make in 2008. However, we find it difficult to see how the ACCC could find that ULLS-based competition is preferable in the long-term when there is a very high probability that the ULLS will no longer exist in less than 10 years. NBN Co is proposing to offer layer 2 services that will remove the need for access seekers to have active equipment located in Telstra exchanges. This will create widespread asset stranding (even if the costs of these investments have been recovered). In that light, it is not surprising that [c-i-c].

The NBN developments raise the issue of whether it would be genuinely efficient to encourage duplication of investments in sunk assets (i.e. those which have no alternative value when the NBN is rolled out). The ACCC claims in a number of places in the Discussion paper that investment will occur where it is efficient to do.<sup>31</sup> However, access seekers will not invest where it is *efficient* but where it is *profitable*. These are not the same thing. Investment can be profitable but inefficient; for example, if Telstra’s prices include monopoly rents too much entry may occur.<sup>32</sup>

Our view is that the ACCC should revisit the cost-benefit calculus that has in the past favoured competition involving large investment in sunk assets. Historically, the benefits derived from competition – lower prices, productive efficiencies and product innovation – may have outweighed the costs of overinvestment in sunk assets (including excess capacity and loss of scale economies). But now this balance has changed. Encouraging new investment in assets that will become stranded is unlikely to be more efficient than encouraging greater use of Telstra’s existing assets. These assets can be used to supply wholesale voice services at very low marginal social cost.

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<sup>31</sup> For example, p. 236 and p. 242.

<sup>32</sup> More generally, see N. Gregory Mankiw and Michael D. Whinston, “Free Entry and Social Inefficiency” *The RAND Journal of Economics*, Vol. 17, No. 1 (Spring, 1986), pp. 48-58

## 6 Conclusions

From our analysis, we conclude the following:

- The development of the FADs gives the ACCC an opportunity to re-visit its earlier decisions about the granting of exemptions to regulation for WLR, LCS and PSTN OA services. It can review whether its expectation that wholesale prices for these services would be constrained by competition in exempt areas has been fulfilled, and can re-consider whether the increasing certainty around the NBN changes the balance in favour of buying rather than building.
- Our analysis of the relevant markets has shown that both the ACCC and the Tribunal did not sufficiently consider the effects of granting the exemptions on markets for fixed voice only services. In these markets, Telstra holds a very strong position and faces little competition at the wholesale level. There is little possibility of effective entry by new entrants and little interest shown by ULLS-based access seekers in providing wholesale fixed voice services.
- Our analysis of new entry prospects has shown that the NBN is highly likely to present an important additional stumbling block to new investment in supplying voice only services. It is therefore not surprising that Telstra now proposes to lift prices in exemption areas and that there appears to be little prospect of that price rise being defeated by new entry.
- It follows from our analysis that incorporating the exemptions is likely to hinder competition in the relevant downstream retail voice market rather than promote it.
- We also question whether the ACCC has placed sufficient weight on the efficiency of new investment in its Discussion paper. The long term move towards the NBN will strand any investments made subsequent to the exemption decision, and there is no certainty that the efficiency benefits derived from these investments will outweigh the efficiency costs. Resale competition appears to be a more productive use of scarce resources in these circumstances, and this will depend on continuing and effective access to WLR, LCS and PSTN OA services.

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