IT'S HOW WE CONNECT

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Australian Competition and Consumer Commission
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Dear Mr Cosgrave,

Exemptions for competitive WLR, LCS and PSTN OA services

In the context of Structural Separation Undertaing (SSU) discussions, the ACCC and Telstra have discussed the exemptions of WLR, LCS and PSTN OA services that apply in competitive Exchange Service Areas (ESAs). As discussed, given that the ACCC is shortly to reach a decision on this matter, I am writing to take the opportunity to persuade the Commission that should they make a decision to re-regulate these services in competitive ESAs by withdrawing the exemptions, there should be no presumption that prices in current access determinations should apply in competitive ESAs. Rather a proper inquiry as to the appropriate price terms should be undertaken.

To facilitate consideration of this issue, I have also taken the opportunity to summarise in this letter the substantial body of evidence already submitted by Telstra that the relevant ESAs are competitive.

Current access determinations should not apply to currently exempt services, even if exemptions are withdrawn

The FAD prices applied to bottleneck services are inappropriate in competitive ESAs

The ACCC issued final access determinations in relation to fixed line services, including non-exempt WLR, LCS and PSTN OA services, in July 2011.The prices for these services are set at a level that is less than Telstra's accounting costs (see footnote 3), with capital costs valued on the basis of Telstra's depreciated historic costs (except for a small increment added to the depreciated value of duct capital). The basis for moving from a replacement cost approach to an accounting based approach included that the objective of promoting efficient build/buy incentives is less relevant for services that are an enduring bottleneck. The ACCC stated:[1]

> *"…one of the key rationales for the re-valuing the RAB in telecommunications was that it would send 'efficient build or buy' signals. This objective reflected an expectation that there was a greater potential for infrastructure-based competition in telecommunications than in other regulated infrastructure industries — that is, telecommunications infrastructure was not an enduring bottleneck. It was expected that, in telecommunications, the least cost technology would be rapidly and continually changing, so that access seekers would, over time, be able to efficiently*

[1] ACCC (2009), *National Broadband Network: Regulatory Reform for 21st Century Broadband: Submission to the Department of Broadband, Communications and the Digital Economy*, June 2009, pg 52.

> *deploy their own infrastructure to compete with the incumbent's and provide services in downstream retail markets."*

However, it cannot be said that WLR, LCS and PSTN OA supplied in exempt areas are enduring bottlenecks for wholesale customers, given healthy competition at the retail level (as summarised below) and the alternative forms of supply available (most importantly, the regulated ULLS). Therefore, build/buy incentives for exempt WLR, LCS and PSTN OA services are still very relevant as wholesale customers are constantly aware of their options to buy these currently exempt services or build ULLS networks.

There is a high potential risk of real competitive harm if the ACCC were to re-regulate prices for services supplied in competitive ESAs, on the incorrect basis that they constitute an enduring bottleneck. This would particularly be the case if prices in competitive areas are set to the ACCC's measure of accounting cost (which we submit is less than Telstra's actual accounting cost).

The ACCC itself has raised the merits of having different pricing approaches for wholesale transmission services facing different competitive restraints:[2]

> *"This mix or combined approach is discussed in the Frontier Report, which notes that it would seem desirable to impose less intrusive regulation in areas that are prospectively competitive and to reserve cost-based methods for where there are discrete markets in which competition seems unlikely. Further, this approach is consistent with the ACCC's view that TSLRIC+ may not be appropriate in markets where build/buy decisions are not relevant.*

This approach would support a different pricing approach for currently exempt services.

<u>Price equivalence is delivered by competive discipline and an enforceable EOO commitment in the SSU</u>

There is no urgency to change prices in the currently exempt ESAs because the competitive state of these ESAs, in conjunction with Telstra's commitment to equivalence of outputs (EOO), including price equivalence, in the SSU, means that price equivalence will be delivered in these ESAs.

With respect to competition in the markets for the supply of exempt services, by granting the exemptions, the ACCC and Tribunal found that Telstra's pricing of exempt services in those areas was subject to a high degree of competitive discipline, which, as discussed in the section below, has become stronger since those exemptions were made.

Competitive discipline delivers equivalent outcomes:

- In granting the exemptions, the ACCC/ACT identified they would promote competition relative to those services being declared;
- Telstra's list prices in exempt areas for LCS and PSTN OA are equal to the access determination prices in non-exempt areas;
- Telstra's list prices in exempt areas for WLR are less than the ACCC's regulated price for this service once removed. While the WLR prices in exempt areas are greater than the WLR prices in non-exempt areas, there is no correlation between the prices that

[2] ACCC (2010), *An ACCC Discussion Paper Reviewing Pricing of the Domestic Transmission Capacity Service*, April 2010, pg 24.

would be expected (and indeed observed) in competitive markets and the prices in non-exempt areas, which are set equal to the average accounting costs calculated by the ACCC's FLSM;[3]

- The requirement for the SSU to provide for appropriate and effective equivalence does not apply to the supply of WLR and LCS in CBD areas, as these are not declared services because the ACCC deemed they were effectively competitive – Telstra submits that competition for exempt services is as strong as it is in CBD areas and similarly sufficient to satisfy the ACCC that equivalence is already being provided;

- Any attempt to operate in a non-equivalent way in competitive exempt areas, will result with the substantial risk of bypass to ULLS based self- or third party supply of the exempt services.

Notwithstanding the competitive nature of the supply of exempt services, the ACCC retains the power under Part XIC to re-regulate the pricing of services in exempt areas in the future, through an access determination or by issuing a binding rule of conduct.

Furthemore, the SSU contains the following measures that deal with prices for exempt serices:

- Transparency of pricing for exempt services is provided for in the SSU by including the prices for these services on the rate card.

- Under the SSU, internal and external wholesale prices will be published on a national basis, which will therefore encompass internal and external wholesale prices for exempt services. In the event that there is a material difference between the internal and external wholesale prices, the ACCC will be given the information (by substantiation report or other information gathering powers) to determine whether there is non-equivalence. Further, the ACCC can issue binding rules of conduct or access determinations to remedy any such non-equivalence, including with respect to regulated but exempt services.

- The SSU commits Telstra to an over-arching equivalence of outcome (EOO) standard, including in relation to prices for exempt services. Should the ACCC consider that there is a lack of equivalence with respect to declared but exempt services, then the ACCC is able to notify Telstra of a breach of the EOO standards and impose a rectification plan to remedy that breach. Telstra could also face penalty or compensation costs.

Given the market and regulatory context (including based on market conclusions reached by the ACCC and Tribunal), equivalence and transparency with respect to the price terms for exempt services will be provided for in an appropriate and effective manner, even without the re-regulation of currently exempt services.

[3] The FLSM calculates WLR prices at a level less than Telstra's accounting cost of providing those services. Accounting costs, generally, are not a valid approximation of competitive prices or prices that reflect market power. See American Bar Association of Antitrust Law (2005), *Market Power Handbook: Competition Law and Eonomic Foundations*, ABA Publishing: Illinois, Chapter C;Church J. and Ware, R. (2000), Industrial Organisation: A Strategic Approach, Boston, MA; Irwin McGraw-Hill, ch. 12 generally and from pg 432 specifically. The FLSM sets prices lower than Telstra's accounting costs by way of its approach to not accounting for declining demand to 2013/14. With respect to WLR, Telstra's accounting costs from 2009/10 to 2013/14 are divided by demand in 2009/10, despite the accepted trend of declining demand. With respect to LCS and PSTN OA, Telstra's accounting costs associated with switching from 2009/10 to 2013/14 are divided by demand in 2002/03, again despite the accepted trend of declining demand.

Recommendation

Accordingly, should the ACCC determine that the currently exempt WLR, LCS and PSTN OA services should be re-regulated, then Telstra proposes that the ACCC:

- Conclude its inquiry into the variation of the current fixed line services FAD by imiting the application of the terms and conditions in that FAD so that they will not apply by default to the currently exempt services when the exemptions are removed;
- Issue an IAD for the currently exempt services at the prices proposed in the SSU (not the prices the ACCC determined suitable for areas where there is an enduring bottleneck); and,
- Undertake proper consultation in relation to a FAD that would replace the IAD for the currently exempt services.

The relevant ESAs are competitive

Since Telstra first applied for geographic resale exemptions in 2007, the underlying logic of the case for exemptions has been tested and endorsed by the Commission in 2008, the Federal Court in 2009, and the Australian Competition Tribunal (Tribunal) in 2009. That is, that ULLS-based competition is able to drive greater competitive outcomes and will better promote the LTIE than resale-based competition.

Since the time of these decisions, ongoing ULLS-based investment by access seekers within the 380 ESAs eligible for exemption has driven intensely competitive outcomes. At the retail layer, end user prices are decreasing, the variety of differentiated service offerings and value added features have grown considerably, and there has been a significant rebalancing in market shares. At the wholesale layer, Telstra has maintained supply of WLR services (at a continuing discount to its Standard Access Offer rate) in an effort to compete with the self-supply of resale services by ULLS-based access seekers.

As at September 2011, competitive conditions within the 181 ESAs that have been made exempt to date (exempt ESAs) far exceed the strict threshold conditions established by the Tribunal[4]. Not only do the competitive conditions within the exempt ESAs surpass the requirements established by the Tribunal, they have also developed to be at least as competitive – if not more competitive – than conditions within CBD ESAs. This has been primarily driven by ULLS-based competition, such that within the Exempt ESAs ULLS has a higher market share (21.3%) than in CBD areas (17.6%)[5] (and, conversely, WLR has a lower market share in the exempt ESAs than in CBD ESAs). There are also more active ULLS-based access seekers within the exempt ESAs (17) than in CBDs (14)[6]. Overall, the prevailing competitive conditions within the exempt ESAs appear to be at least as competitive as the conditions in the unregulated CBD ESAs.

One of the concerns raised in the consultation process is that there has not been significant new entry in the market for wholesale resale services. Telstra considers this concern to be misplaced as it focuses narrowly on a particular sub-market structure and ignores the competitive outcomes that are occurring. First, at the time the Commission and the Tribunal determined to grant the resale exemptions, both bodies considered that *if* Telstra were to withdraw supply or increase the price of these resale services, third party entry (using ULLS

[4] The Tribunal's exemption orders set a far higher bar for exemption via its conditions and limitations – than the ACCC's 2008 decision requiring, amongst other things, not only that 3 or more ULLS-based operators were present in an ESA but that they had an aggregate addressable market share in that ESA of greater than 30%.
[5] Based on the Tribunal's "Aggregate Market Share" definition which takes into account WLR lines and spare capacity ULLS based access seekers have an addressable market share of 49% in the Exempt ESAs versus 46% in the Exempt areas compared to the Tribunal's threshold of 30%..
[6] Although the average number of ULLS entrants in CBDs stands at 8.5 to 6.3 in the Exempt ESAs (still more than double the ACCC's and Tribunal's previous decision threshold of 3 ULLS-based entrants).

as an input) would be possible. However, since the exemptions came into effect, Telstra has continued to commercially supply resale voice services at the same standard prices that have been in place from 2005. The success of ULLS-based access seekers at the retail level (in effect self-supplying resale services) is indirectly constraining Telstra – necessitating that it maintain supply and seek to grow resale traffic on its network.

There is no evidence to suggest that the exemptions are preventing or deterring efficient investment from taking place, or are damaging competition at the retail level. On the contrary, the data clearly shows that ongoing investment by access seekers has led to a greater range of competitive offerings, lower prices and a rebalancing of market shares.

In addition, data from the upcoming quarter of CAN RKR data is likely to show a continuation of the pattern of ongoing expansion in ULLS–based access services and investment in ULLS capacity, growing ULLS market share and declining Telstra retail share.

Ultimately, given that less than 12 months has passed since the exemptions first came into effect, it is far too soon to accurately assess their full impact. However, in the short time since the exemptions commenced, all available evidence – ranging from access seekers' continued investment in ULLS-based infrastructure, to the competitive outcomes observed across both the retail and wholesale fixed line voice services – suggests that the market conditions within the Exempt ESAs are better than had been anticipated at the time the exemptions were first granted.

Ultimately, a decision to remove the exemptions in the exempt ESAs would give rise to a stark inconsistency – namely, the reinstatement of regulated access to resale services in ESAs displaying market outcomes which are at least as competitive as those in CBD, which will remain unregulated notwithstanding the Commission's decision in the current variation to FAD process.

It is in this context that Telstra makes the submissions above in relation to pricing of these services in the event the exemptions are revoked.

Conclusion

Telstra submits that currently exempt ESAs are competitive and that price equivalence and transparancy is provided for in an effective and appropriate manner by competitive discipline and the additional measures in the SSU. If the ACCC nonetheless determines to re-regulate these services, the ACCC must turn its mind to what terms and conditions should apply to these services in competitive areas, since it is clear that price regulation based on the assumption of an enduring bottleneck is unlikely to be appropriate with respect to these services, and urgent price intervention is not required.

Yours sincerely

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