



# DECLARATION OF THE DOMESTIC TRANSMISSION CAPACITY SERVICE

Response to the  
Australian Competition  
and Consumer Commission

Public version

30 August 2013



## Contents

1. Executive summary .....	2
2. Relevance of the DTCS declaration .....	5
3. State of competition in currently deregulated areas .....	9
4. Relevant markets for the DTCS .....	10
5. The DTCS service description .....	11
6. The effect of the NBN .....	12
7. Assessing competition for the DTCS.....	12
8. Special linkage charges .....	14
9. Technologies used to provide transmission services .....	15
10. Duration of the declaration .....	15
11. Approach to pricing of the DTCS .....	15
12. Conclusion .....	17
Attachment 1: Market Clarity, Backhaul Fibre by Owner, 22 August 2013.....	19



# 1. Executive summary

Vodafone Hutchison Australia Pty Limited (**VHA**) welcomes the opportunity to participate in the Australian Competition and Consumer Commission's (**ACCC**) consultation on whether to extend, vary or revoke the domestic transmission capacity service (**DTCS**) declaration, or whether to make a new DTCS declaration.

The DTCS is an essential input to the full suite of fixed and mobile communications services and this review comes at a critical time. The recent explosion in demand for data on both fixed and mobile networks makes the availability of DTCS at reasonable prices critical for the delivery of fast and reasonably priced services to Australian consumers. Voice, broadband, video and text rely on the availability of DTCS to connect many exchanges, points of presence (**POPs**) and base stations to core networks and beyond. This, when coupled with the natural monopoly characteristics associated with transmission capacity services in many parts of Australia, provides a compelling case for retaining, and indeed expanding, the current declaration of the DTCS.

The impact of the ACCC's inability to overcome Telstra's overpricing of the DTCS has resulted in pervasive and damaging limitations to competition and investment in Australian telecommunications. Structural reform of the Copper Access Network (and the upgrade of this infrastructure) is welcome. The next great structural problem in this market is Telstra's stranglehold over many parts of the transmission market; with inter-capital and a limited number of other routes the only notable exceptions. Reform to the regulation of DTCS is urgently needed.

The ACCC's current approach to the regulation of the DTCS has deprived consumers of the benefits of competition and innovation for three reasons:

- Too many transmission markets have been exempted from regulation by the mechanical application of a test which fails to accurately measure the real level of contestability on individual routes. This means consumers missed out on effective competition from new entrants.
- The regulatory framework for the DTCS, with its selective coverage of Telstra's transmission network, has been fundamentally ineffective at constraining Telstra's ability to exert market power in the supply of transmission services. Again, this limits the expansion of competition in new markets resulting in higher prices, less innovation and poorer service.
- The ACCC's 2012 Final Access Determination (and the regression model it is based on) have demonstrably failed to deliver cost-based pricing for the DTCS. Telstra's unacceptable and unjustifiable high prices for DTCS have not been overcome and this has had serious ramifications for Australia's competitive landscape, particularly in regional Australia. The most obvious manifestation of this is limited mobile competition in regional Australia. Without cost-based pricing, the benefits of declaration are largely ephemeral. Australia has some of the highest fixed line prices in the world. A lack of competition caused by high DTCS prices is a key contributor to this as it limits unconditioned local loop competition. It is also a major constraint to competitive mobile coverage expansion.



These concerns can be addressed by the ACCC as part of its current inquiry and its subsequent consideration of a new final access determination (**FAD**) by three straight-forward actions:

1. The ACCC must modify its test for the removal of regulation by undertaking a more detailed assessment of the actual level of competition in markets where there are 2 or 3 providers other than Telstra. That assessment must involve an investigation into the competing services being supplied as well as the infrastructure in the ground. Effective competition is what drives the efficient outcome.
2. The ACCC must abandon its flawed benchmarking approach to the pricing of the DTCS and develop a model capable of assessing the true cost of supplying the DTCS. The best (and easiest) way to do that is by constructing a robust building block model that would bridge the gap between the FAD pricing and Telstra's true costs. The access regime was established in its modern form in 1997. After 16 years it is simply unacceptable that the ACCC does not to embark on this exercise.
3. The ACCC's approach to the DTCS must explicitly address the economic significance of Telstra's self supply of the DTCS. A failure to do so is at the heart of the problem with the ACCC's regression model. It is crucial that the ACCC ensures that there is a level competitive playing field. Current regulation of the DTCS has not delivered this.

Without these changes, the extent to which declaration of the DTCS promotes the LTIE will be severely compromised and Australia's skewed market structure will persist to the detriment of Australian consumers. With these changes, the increases in competition and allocative efficiency will inevitably lead to better outcomes for consumers, particularly in regional and remote areas.

## Conclusion

DTCS regulation has been flawed for over a decade. First, the previous regulatory regime did not allow a holistic assessment of appropriate DTCS pricing (rather each DTCS link had to be assessed separately). Second, in the first pricing determination under the improved access regime, the ACCC determined pricing that still allowed Telstra to overcharge for these services and to inappropriately use its market power to limit competition. The impacts on the Australian market are profound. In particular, it has resulted in limited fixed broadband competition in regional areas and severely limited the ability of competing mobile network operators to build mobile infrastructure in regional Australia. Now is the time for the ACCC to overcome these problems.

The time is right to overcome the profound distortions of Telstra monopoly power in this part of the telecommunications industry. The material effects of improved regulation will be pervasive, extensive and welcome. It will deliver a long overdue improvement to the entire Australian telecommunications market.

The key problem in the regulation of DTCS is the ACCC's use of a regression model to determine the regulated prices of the DTCS. Bundling of the DTCS across undeclared and declared routes coupled with the use of price discrimination by Telstra ultimately means the regression model is fundamentally flawed. **[c-i-c]**. As a result, competition and investment, particularly in regional areas, is impeded.



It is imperative that the ACCC begin to address these concerns now, as part of its current inquiry, particularly as VHA has evidence that market prices are in some cases close to one third of the price generated by the ACCC's regression model. That evidence demonstrates that the ACCC's regression model pricing can deliver 'super normal' profits to suppliers of the DTCS. This is a perverse and destructive regulatory outcome. It results in service providers facing significant barriers to enter a range of markets, thereby limiting expansion by downstream fixed and mobile service providers into many parts of Australia. The only beneficiary of this is Telstra.

Another major weakness in the ACCC's regulation of DTCS is the way the ACCC has lifted oversight on Telstra's commercial provision of this service. The idea that just because there is the possibility of two providers being able to offer a comparable service in an area to Telstra means that there should be no regulation is simplistic and has led to economically inefficient outcomes. As a general principle, VHA welcomes regulation being effectively lifted from competitive markets. However, in this case its removal has damaged rather than enhanced competition.

VHA's submissions on these issues and some of the questions posed by the ACCC in its discussion paper are set out below.



## 2. Relevance of the DTCS declaration

### 2.1 The importance of the DTCS declaration

Declaration of the DTCS is essential because the service is such a critical input to the provision of the full suite of fixed and mobile communication services to all Australians. Without declaration, carriers other than Telstra would be at a massive disadvantage in competing for customers in downstream markets as Telstra continues to have a virtual monopoly on the DTCS in many parts of Australia and, in particular, in regional and remote areas.

As a vital input to the downstream services, the DTCS represents a substantial proportion of VHA's overall cost of supply. That cost is particularly significant in regional markets. Transmission costs are estimated to represent [c-i-c] and demonstrate the economic significance of the DTCS to VHA and the need to ensure a robust, principled approach is taken to the declaration of the DTCS and the ACCC's subsequent access determination.

[c-i-c]

The DTCS has become more critical with the dramatic increase in consumers' demand for fixed and mobile broadband and the effects of Telstra's overpricing cannot be overstated. Rising data demand has driven the need for network capacity (including the capacity provided by transmission links) in recent years, making declaration of the DTCS ever more important to ensure the provision of fast and reasonably priced services to consumers. In the absence of economically efficient, cost-based access to the DTCS, rapid advances in technology such as 4G and LTE will not be exploited to their full potential and end-users will miss out.

### 2.2 Approach to regulation

The DTCS is often conceived of as being a difficult service to regulate. There are tens of thousands of potential routes, variations in the capacity and quality of service requirements sought by access seekers and differences in the technology used to deliver the service. These complications should not deter the ACCC from developing a robust, cost-based framework for the regulation of the DTCS.

The perceived complexity stems largely from the ACCC's traditional perspective that each link needs to be assessed in relative isolation. A better approach (and it is an approach that the ACCC has undertaken in the fixed services area) would be to assess the total costs of DTCS infrastructure and then determine a price that can be applied on particular types of links. With this approach, 'revenue constraint' regulation is relatively straightforward to apply.



Regulators in other jurisdictions have addressed the complexity of the service by taking this more holistic approach. For instance, Ofcom in the United Kingdom (**UK**) recently completed its *Business Connectivity Market Review* (**Ofcom Review**).<sup>1</sup> Some of the critical issues dealt with in the Ofcom Review include:

- recognition that the mere presence of other operators in a market is insufficient to establish competitiveness – that competition must be effective;
- mechanisms to address the extension of operators' transmission networks, which are often undertaken on a customer-by-customer basis and referred to in Australia as 'Special Linkage Charges' (**SLCs**) (see discussion at **section 8** below);
- recognition of incumbency advantages including the ability to serve new customer sites faster and lack of reliance on third party services; and
- recognition of the cost advantages the incumbent has in upgrading its transmission technology due to its widespread ownership of passive infrastructure.

This has two implications for the declaration of the DTCS in the Australian context. First and foremost, the ACCC should broaden the scope of the declaration to include all routes or markets that are not demonstrably effectively competitive. VHA expects that this would result in a significantly greater number of Telstra's routes being declared. Further, once declared, Telstra's maximum charges should not be linked either to other operators' charges or to Telstra's own charges where other operators are present. This is because:

- Even where other operators are present, Telstra's costs of provision will usually be much lower as it is likely to require significantly less network build, or even none at all.
- Where Telstra's prices are above the cost required for new network build, an alternative operator can price higher than it would be able to in an effectively competitive market.
- Absent declaration, there are only limited circumstances where Telstra will be incentivised to price at a genuinely competitive level, i.e. at a price which reflects costs and no more.
- To deliver a level competitive playing field, it is crucial that Telstra is not in a position to price above cost for such a foundational product.

Second, the ACCC is in a position to seriously consider broadening the scope of the DTCS (or considering new declarations) to cover Wavelength Division Multiplex (**WDM**) technology and dark fibre. In VHA's view, it should do so (as discussed further in **section 5.5** below).

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<sup>1</sup> Ofcom (2013), *Business connectivity market review – final statement*, <http://stakeholders.ofcom.org.uk/consultations/business-connectivity-mr/final-statement/>, 28 March (Accessed, 28 August 2013).



## 2.3 The DTCS declaration continues to remain relevant

The fundamental economic rationale for declaration is to promote the long-term interests of end-users (**LTIE**). The LTIE is promoted through:

- promoting competition;
- promoting the achievement of any-to-any connectivity; and
- encouraging the efficient use of, and investment in, infrastructure.

The impacts of declaration on competition and economic efficiency (productive, allocative and dynamic) need not be immediate or limited to the markets which are subject to declaration. Rather, the LTIE is promoted where regulation results in long term benefits for consumers.

In the case of the DTCS, declaration must overcome Telstra's ability to attract economic rents on parts of its network which exhibit natural monopoly characteristics while continuing to aggressively compete on other parts of its network where it faces some degree of competitive constraint. While the point-to-point nature of some (but not all) transmission services may make it useful to consider various capital, metropolitan and regional routes as separate markets, the ACCC must also consider the scope of the declaration of the DTCS in light of the market failure which declaration seeks to address – Telstra's enduring ability to exert market power by virtue of its interconnected, nationwide and ubiquitous fibre transmission network. VHA considers that the ACCC should take into account the comprehensive nature of Telstra's fibre transmission network in its approach to regulation of the DTCS, particularly as VHA and most other access seekers generally do not negotiate with Telstra for prices on a route-by-route basis.

There can be no doubt that the DTCS remains an enduring and counter-productive bottleneck in a significant number of areas. Indeed, there are several areas where declaration has been lifted prematurely as a result of the ACCC's decision to grant exemptions using a test which fails to accurately measure the level of contestability in those markets (discussed further in **sections 3 and 7** below).

As demonstrated in the Market Clarity Backhaul Infrastructure Map (**Attachment 1**), Telstra's fibre network is the only network which links geographical areas across all of Australia.<sup>2</sup> As a result, Telstra is the only viable supplier of transmission services for access seekers who wish to provide a national service to end-users in downstream markets. This is for three reasons:

- access seekers are forced to utilise Telstra's transmission services in certain geographical markets where there are no viable alternative suppliers present;

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<sup>2</sup> Note that the backhaul fibre networks of some of the fibre owners depicted in the map overlap with Telstra's network. Where a fibre owner's network is depicted on the map, it is superimposed over the top of Telstra's network.





- access seekers experience cost benefits (including service efficiencies and reduced transaction costs) from utilising one supplier as the provider of transmission services, rather than multiple suppliers; and
- Telstra deliberately (and, for a dominant player, rationally) prices its services in a manner designed to secure national bundled deals comprising both declared and undeclared DTCS. This is to the clear detriment of consumers in downstream markets, particularly those in regional and rural areas.

As a result, despite declaration, flawed regulatory oversight has ensured that Telstra continues to exploit its market power and enjoy the benefit of economies of scope and scale, to the detriment of competition. For the reasons set out in **section 2.4** below, VHA is concerned that Telstra might be exploiting the weaknesses in the current regulation of the DTCS by pricing transmission services for routes on which there is competition at (or near) cost, and bundling those services with services for regional routes on which there is no competition (and which are priced above cost). This is problematic as it significantly limits the ability of other infrastructure owners to provide a genuine competitive constraint on Telstra. For these reasons, declaration of the DTCS, when coupled with appropriate pricing principles to attain efficient pricing, will encourage service providers to purchase optimal amounts of transmission services, promoting competition in both the wholesale transmission services market and also in the downstream markets.

The uncompetitive nature of a significant number of geographic routes for the DTCS means that, without declaration, Telstra may significantly raise the cost of accessing its transmission infrastructure, hindering an access-seeker's ability to achieve end-to-end connectivity and compete with Telstra in downstream markets. For these reasons, declaration is essential to promote any-to-any connectivity between networks and end-users.

Transmission networks require large upfront investments, making it economically inefficient for competitors to duplicate existing transmission network infrastructure in certain geographic markets. Entry has generally been limited to service providers which are, or have become, vertically integrated (that is, Telstra, Optus, TPG/Pipe Networks and AAPT), with NextGen being the sole exception. Where there has been competition, it has also tended to focus on 'backbone' transmission and substantially less so on 'tails'. The further the site is from 'backbone' fibre rings the less the competitive constraint on Telstra.

Above cost-pricing of the DTCS has also deterred downstream investment by service providers and limited competition in some geographic markets. These impacts can be observed by the vastly different competitive outcomes between metropolitan and regional areas; outcomes that are driven, in significant part, by lack of access to the DTCS on reasonable terms and conditions (see **Figure 2** below). Declaration of the DTCS, coupled with cost-based pricing, will promote the efficient use of infrastructure by allowing access-seekers to access transmission infrastructure at economically efficient prices and encourage economically efficient investment in infrastructure. This will not solve all the constraints of regional competition but it is a necessary part of overcoming Telstra's market strength in regional Australia.



**Figure 2: Estimated retail mobile market shares by geographic area**

[c-i-c]

For these reasons, and considering that the DTCS is an essential input for a number of other services, declaration is essential in order to promote the LTIE.

## 2.4 Should parts of the DTCS declaration be varied or extended?

The ACCC should refine the simplistic 'rule of thumb' that it uses to determine whether or not a geographic route is declared. The mechanical application of the 'Telstra+2' test fails to accurately measure the level of contestability on regional routes and in metropolitan inter-exchange markets, and has almost certainly led to uncompetitive markets becoming deregulated. This is discussed further in **sections 3 and 7**.

Furthermore, the ACCC should recognise that, even with declaration, Telstra has the ability and the incentive to exploit its market power in transmission services by respond aggressively on contestable routes while keeping prices on monopoly routes above the regulated price. The capacity for price discrimination of this nature has enormous potential to damage downstream competition by distorting access seekers' investment decisions and causing uneconomic diversion of demand for the DTCS on declared routes. **[c-i-c]**. These effects are most pernicious in the case of vertical integration when access seekers do not receive access to the DTCS on equivalent terms as Telstra supplies to itself. Lack of equivalence creates an uneven playing field, distorting competition and harming the LTIE.

The problem caused by the overly narrow scope of the DTCS declaration has been exacerbated by the use of the regression model to determine the regulated prices of the DTCS. Bundling of the DTCS across undeclared and declared routes coupled with the use of price discrimination by Telstra ultimately means the regression model is fundamentally flawed. In practice, Telstra routinely charges reduced prices on contested routes (demonstrating that the ACCC has overpriced the service in many areas) while extracting economic rents on monopoly routes (demonstrating that ACCC's pricing has allowed Telstra to inefficiently exert its market dominance). As a result, competition and investment in regional areas is impeded.

[c-i-c]

## 3. State of competition in currently deregulated areas

A significant number of routes which VHA considers to be natural monopolies or are otherwise uncompetitive have been deregulated as a result of the mechanical application of a test which fails to accurately measure the level of contestability in that market. The inadequacy of such an approach has been recently recognised by Ofcom in the Ofcom Review referred to in **section 2.2** above. Instead, the ACCC should take an evidence-based approach and obtain data (for example, by using its power to make record keeping rules (**RKRs**)) on routes which have been exempted from regulation to determine whether prices have increased.



## 4. Relevant markets for the DTCS

### 4.1 Product markets

The ACCC previously identified the relevant downstream markets for the DTCS as:

- the range of retail services which are delivered over optical fibre including national long distance, international call, data and IP-related markets; and
- the mobile services market, including voice and data.

VHA considers that these markets continue to be the relevant downstream markets for consideration of the DTCS.

### 4.2 Geographic markets

The ACCC previously identified the following geographic markets for the DTCS:

- inter-capital transmission;
- capital-regional routes;
- inter-regional routes;
- local exchange and tail end transmission in regional, metropolitan and CBD areas.

VHA supports these distinctions, however it is also necessary to define a national market for transmission services in addition to defining individual routes for the aforementioned geographic markets. As the ACCC has frequently acknowledged,<sup>3</sup> it is important that market definitions be purposive. Over-segmentation of the geographic market definition ignores the market power and scale economies Telstra derives through its vertical integration and economies of scale over its entire fibre transmission network.

Interestingly, though the comments were made in relation to the wholesale mobile services market, the US Federal Communications Commission (**FCC**) recently stated that the offerings of a national provider of wholesale services with an integrated network over the country cannot be replicated by regional or smaller providers and thus, these smaller operators are not able to effectively constraint the market power of national operators.<sup>4</sup> While the idiosyncrasies of the US regulatory system may not be directly transferable to Australia, this finding suggests the issue of geographic market definition warrants careful consideration.

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<sup>3</sup> For all, see Section 2.2.1 of the ACCC's Final Decision and Class Exemption on *Telstra's local carriage service and wholesale line rental exemption applications* of August 2008 and Section 2 of the ACCC's Final Report on its *Inquiry into varying the exemption provisions in the final access determinations for the WLR, LCS and PSTN OA services* of December 2011.

<sup>4</sup> FCC's Staff Analysis and Findings as regards the proposed merger between AT&T and T-Mobile (WT Docket No. 11-65), paragraph 109.



## **5. The DTCS service description**

### **5.1 Defining geographic boundaries in the DTCS service description**

The ACCC has previously excluded routes from the DTCS service description which have been found to be competitive, including routes between transmission points located in exempt capital cities (inter-capital routes) and between exempt capital cities and specified regional centres (capital-regional routes). In the 2012 DTCS FAD, the ACCC defined the geographical boundaries of each capital city and regional centre. VHA considers that the geographical boundaries of capital cities identified in the DTCS FAD are appropriate and should be adopted in the DTCS service description as part of this current inquiry.

The boundaries of regional centres should be determined by reference to the distance from the main exchange within the regional centre. Where other exchanges are present in a regional centre, each exchange should be subject to a competition assessment to determine whether competitive effects differ according to the different exchanges.

### **5.2 Aligning the DTCS service description with the DTCS FAD**

The DTCS FAD identifies the geographic route categories of the DTCS as regional routes, metropolitan routes and tail-end services. These categories are broadly appropriate.

VHA often acquires transmission capacity as tail-end services bundled with the relevant capital to regional or metropolitan route being acquired. For this reason, VHA recommends that consideration be given to the geographic route categories in the DTCS service description being amended to explicitly bundle tail-end services with regional or metropolitan routes.

### **5.3 Protected DTCS services**

The ACCC's current service description for the DTCS includes both 'protected' (i.e., diverse or redundant path) and 'unprotected' DTCS. VHA considers that both types of services should continue to be declared as both are critical inputs for downstream fixed and mobile services. In addition, VHA considers that the DTCS FAD definition of 'protection' should be adopted in the DTCS service description.

### **5.4 Relevance of 'contention' and 'symmetry'**

The different functionality and purpose of symmetric and asymmetric transmission services means that the two services are not close substitutes. Symmetric services support equal bandwidth in both directions, and are used for voice calls and data transfers where the user uploads and downloads in roughly equal amounts.

### **5.5 Declaration of WDM technology and dark fibre**

VHA considers that both WDM and dark fibre will become increasingly important inputs for the supply of mobile services due to the exponential increase in demand for data by end-users. Both services, when acquired at the right price, can be useful for improving the scalability and robustness of transmission solutions in the access



network. Furthermore, dark fibre is commonly provided in the backhaul market and it is anomalous that these services are not included in the declaration. There would be significant opportunities to improve market conditions and industry innovation if dark fibre were declared.

The DTCS service description should be expanded to include WDM and dark fibre, as it would promote the LTIE for the same reason as declaration of DTCS promotes the LTIE. If the ACCC considers this beyond the scope of the existing declaration it should commence a separate declaration inquiry for these services.

## **6. The effect of the NBN**

VHA cannot, at this stage, form a view as to whether the NBN will affect the state of competition for the DTCS as the rollout of NBN has not been sufficiently progressed for its likely effects to be predicted with any degree of certainty. Once the NBN rollout is further progressed, the impact of the NBN (including whether or not it has stimulated competition in transmission markets) will need to be assessed by the ACCC on a case-by-case basis.

## **7. Assessing competition for the DTCS**

### **7.1 Required number of fibre providers: the current approach**

Currently, the ACCC uses a 'Telstra + 2' test to assess the level of competition in capital-regional routes (i.e., regional routes) and in metropolitan inter-exchange services (i.e., metropolitan routes). This means that evidence of two fibre networks, in addition to Telstra's network, is taken to be sufficient to establish the existence of effective competition in that market. That test arose out of the ACCC's decision to exempt metropolitan inter-exchange transmission and certain capital-regional routes from declaration in 2008. Now that sufficient time has passed for the impacts of the exemption decisions to be felt, VHA considers it timely for them to be revisited by the ACCC.

VHA considers that many DTCS markets remain uncompetitive, even where there are a number of infrastructure providers in addition to Telstra. The mere existence of infrastructure is, at best, a proxy for competition. As Ofcom has recognised, to confidently deregulate a market a regulator needs to first consider whether that infrastructure has or is likely to give rise to effective competition in the short to medium term.

The ACCC should take an evidence-based approach and obtain data (for example, by using its powers to make RKR's under section 151BU of the CCA or, if necessary, under section 155 of the CCA) on routes which have been deregulated to determine whether prices have increased. While market participants such as VHA can provide some evidence of this, the ACCC is best placed to secure Telstra's cooperation in providing evidence about the level of pricing on routes that were exempted in 2008.

A further problem with the current test is that, in some cases, at least one of the additional fibre providers on the 'Telstra + 2' routes is not really an effective competitor. The test as it currently stands does not take into account the fact that some of the fibre providers in certain geographical areas (mainly regional) are electricity and/or rail providers who do not actually pose a real competitive constraint on Telstra. This is for a number of reasons,



including that it is not easy for an access seeker to transact with them to purchase transmission and because they are unable to compete with the bundled offers provided by Telstra given the more limited scope of their networks.

As a result, it is imperative that the ACCC revise its approach to determining which transmission routes warrant regulation. Rather than the current simplistic 'Telstra + 2' approach, there needs to be a more sophisticated approach that determines whether competitors provide sufficiently comparable services to impose a real competitive constraint on Telstra. This would align regulation of the DTCS with other declared telecommunications services such as the ULLS and MTAS and with the ACCC's approach to mergers analysis where it routinely conducts a thorough review of market conditions before clearing a merger or acquisition. Overly simplistic competition assessments based on the existence of alternative infrastructure should not be relied upon to assess competition in this context. Nor are they relied upon in jurisdictions such as the UK where transmission capacity services are regulated.<sup>5</sup>

## 7.2 Required number of fibre providers: an alternative approach

As an alternative, and as part of this inquiry, the ACCC should move towards a test which involves a more detailed assessment of the actual level of competition in markets where there are only 2 or 3 infrastructure providers in addition to Telstra. That assessment must involve an investigation of the competing services being supplied as well as the infrastructure in the ground. If the ACCC wishes to maintain a 'rule of thumb' approach to its competition assessment, then a more effective regulatory alternative should be used, comprising of the following 'decision rules':

- T + 4 (and above) routes should not be declared if all infrastructure owners are demonstrably providing the DTCS on these routes;
- T and T + 1 routes must always be declared; and
- T + 2 and T + 3 routes are presumed to be declared. This presumption, however, can be rebutted by a more detailed assessment of the actual level of competition in the market, which involves three steps. The first step is for Telstra to provide verifiable information to the ACCC as to costs, level of competition, volume and cost allocation of self-supply (as the level of self-supply goes to scale advantages and hence sustainability of any apparent competition). The second step is to consider whether the alternative fibre providers, particularly if they are rail or electricity companies, actually pose a competitive constraint, having regard to both price and non-price terms of supply (including SLAs). In particular, it should assess whether the alternate providers are able to cost-effectively build 'tails' to the infrastructure. The ACCC should then independently analyse and verify this information, including by consulting with the industry. Finally, the ACCC should publish its decision.

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<sup>5</sup> Ofcom, *Business Connectivity Market Review*, 28 March 2013 (available at: <http://stakeholders.ofcom.org.uk/consultations/business-connectivity-mr/final-statement/>).



This approach should also account for:

- the unobserved part of the market, being what Telstra provides and acquires itself;
- other factors such as population density (rather than just the number of providers on a certain route); and
- the capability of the alternate providers to offer the services that Telstra is able to offer (for example, construction of access tails).

The above approach focuses on the T + 2 and T + 3 routes and allows the ACCC to look more closely at each DTCS market in order to determine whether it is in fact effectively competitive. If it is not, declaration should be reinstated. This will ensure that the LTIE is truly promoted without placing an undue administrative burden on the ACCC.

## 8. Special linkage charges

SLCs are levied by Telstra where it is required to extend the scope of the declared service. Given that they are inextricably inter-linked with the DTCS, it would promote the LTIE for the service to which they relate to and should be included DTCS within the scope of the declaration.

Currently Telstra charges for the building of linking transmission infrastructure on a 'time and materials' basis, for example by building a link between Telstra's Point of Presence and a VHA base station. However, VHA has insufficient visibility as to how the SLC is calculated by Telstra and whether or not Telstra subsequently reuses parts of that transmission infrastructure itself or supplies it to other customers.

VHA considers that the SLC should be cost based, efficient, and should reflect Telstra's ability to reuse / resell the infrastructure. This should be specifically addressed in the FAD and it is an urgent and important additional element of the declaration.

Furthermore, if the ACCC revises its approach to pricing of the DTCS (as discussed in **section 11** below), the ACCC may need to explicitly deal with SLCs in its model to avoid the risk of double dipping. This may require some modelling of efficient 'time and materials' costs.

This approach reflects that adopted in the UK by Ofcom. In the Ofcom Review,<sup>6</sup> Ofcom considered that it was necessary to subject 'excess construction charges' (**ECCs**) (which are equivalent to Telstra's SLCs) to price controls as they are an essential part of the overall provision of regulated services. In summary, OfCom:

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<sup>6</sup> Ofcom, *Business Connectivity Market Review*, 28 March 2013 (available at: <http://stakeholders.ofcom.org.uk/consultations/business-connectivity-mr/final-statement/>).



- imposed a one-off reduction to ECCs to align them with underlying costs and prevent over-recovery;
- removed capitalised ECCs from the asset base to address double recovery of ECC costs;
- set the start charges for various ECCs, on a forward-looking incremental cost basis; and
- following this adjustment of prices to more closely reflect costs, Ofcom then imposed a cap of GBCI-0% on each ECC used for leased line services (the General Building Cost Index (**GBCI**) was the relevant inflation index used).

## 9. Technologies used to provide transmission services

The most versatile and scalable technology for high speed capacity transmission services is fibre-optic technology. The potential alternative technologies, such as ULLS, Local Multipoint Distribution Service (**LMDS**) and Microwave Multipoint Distribution Service (**MMDS**), are generally not substitutes for a number of reasons. For instance, while MMDS is useful for short distance, it suffers from line of sight problems and is reliant on availability of sufficient spectrum, and LMDS does not have the bandwidth required for high capacity transmission services, especially as LMDS is a shared technology.

## 10. Duration of the declaration

VHA considers that the DTCS should be declared for a further three to five years. This term is appropriate as it provides regulatory certainty encouraging firms to undertake investment, while at the same time recognises the rapid pace of change in the contemporary fixed and mobile environment (including due to the roll out of the NBN) and the consequent need for the DTCS declaration to be reviewed more frequently.

## 11. Approach to pricing of the DTCS

### 11.1 Rationale for regulating the price of the DTCS

The ACCC's approach to pricing of the DTCS is of fundamental importance in markets which are uncompetitive and continue to exhibit clear market failure. In order to promote the LTIE, a regulator should attempt to set prices at the level they would be offered in a competitive market where there is close to competitive supply. The best way to achieve this is via a cost-based assessment.

### 11.2 Problems with the current approach to pricing of the DTCS

VHA considers that the ACCC's approach to pricing of the DTCS using a regression model is fundamentally flawed, inconsistent with international best practice and a poor proxy for a cost-based pricing model. Without significant reforms to the pricing of the DTCS the benefits of declaration will be lost. The problems with the regression model include:

- The use of a mean price as a proxy for cost grossly over states the true cost. **[c-i-c]**;





- Regression models can only approximate cost-based outcomes if the market is genuinely competitive and the model takes into account volume discounts. The current model attempts to estimate prices for markets which are not competitive, and ignores volume based discounts of services and linkages between purchasing decisions across different markets;
- There is a lack of transparency in the cost and pricing of the DTCS and acquisition of services. This is particularly the case when part of the acquired route is declared (for example, the tail-end) and part of the acquired route is not declared (for example, the Sydney to Dubbo route);
- The biggest customer (Telstra) is missing. This inevitably inflates prices as Telstra enjoys scale advantages others cannot hope to replicate;
- Data points used to derive the regression equation are not independent<sup>7</sup> – Telstra’s data points, which are used by the ACCC in its regression model, are driven by Telstra’s pricing model **[c-i-c]**; and
- Telstra sets bundled prices, which makes it difficult to assess whether prices are cost-based and distorts outcomes across both markets.

**[c-i-c]**

**[c-i-c]**

Faults with the regression model are most acutely felt in regional markets. The high prices of the DTCS are the major inhibitor to the expansion of fixed and mobile services competition in regional Australia. This clearly does not promote the LTIE and must be promptly addressed by the ACCC.

### 11.3 The solution - cost-based pricing

VHA considers that the ACCC should abandon its benchmarking approach to the pricing of the DTCS and move to an approach capable of assessing the true cost of supplying the DTCS. If it does not, the regulation of DTCS will continue to be significantly flawed and result in the perpetuation of Telstra’s dominance in many markets. In VHA’s view, the only way to assess the true cost of supplying the DTCS is to construct a robust and accurate ‘Building Block Model’ (**BBM**) based on depreciated historic costs. This approach would be consistent with the ACCC’s approach to pricing of other declared services (notably including other fixed line services), and will lead to increases in competition and allocative efficiency. This, in turn, will inevitably lead to better outcomes for consumers, particularly those in regional and remote areas. There is no reason to adopt an inferior regulatory approach for a crucial input such as the DTCS, particularly in circumstances where the market failure in access networks is already being addressed via the NBN.

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<sup>7</sup> Data Analysis Australia (2012), *Updated pricing model for the domestic transmission capacity service*, June, p19.



VHA urges the ACCC not to be daunted by the task of undertaking a cost assessment of the DTCS. The BBM approach (rather than a making a TSLRIC assessment of thousands of individual routes) is straight forward and the benefits of a substantially improved regulatory framework will be profound.

The virtue of using the BBM for the DTCS is that it allows the ACCC to separate four critical elements in regulatory price setting: the asset base, operating costs, usage and pricing. This separation helps to overcome some of the information asymmetry problems regulators typically encounter when setting prices for services as complicated and diverse as the DTCS.

A major advantage with this approach is that it permits aggregation of the asset base and operating costs across the set of regulated services rather than on a service-by-service (or in this case route-by-route) basis. This simplifies the determination of an overall revenue target for the suite of declared transmission services and ensures that target is anchored to the costs of providing the service. The absence of any direct link to costs is the fundamental flaw with the regression model.

A second advantage with the BBM is its inclusion of usage forecasts, which permit an explicit assessment of Telstra's level of self-supply. It is critical that Telstra's own use of transmission capacity assets is taken into account to prevent over-recovery of costs.

Finally, the use of a BBM can mitigate the regulator's lack of cost and demand information for individual routes if the regulated entity is provided with discretion to formulate either a price book or a pricing model to recover its revenue requirement. The independent variables in the regression model provide a useful starting point for identifying factors that should be included in such a pricing model. In that context, benchmarking model outputs between undeclared and declared routes may provide a useful constraint to the implementation of a price model (or price book).

The BBM requires the collection and collation of relevant information. As a first step, VHA considers that the ACCC should take an evidence-based approach and use its statutory levers (RKR's) to obtain information from Telstra as to what its actual costs are, as Telstra is aware of its RAB costs. There is no reason for the ACCC to delay this task until its consideration of a FAD.

If the ACCC is unable to develop a model which adequately estimates the true cost of supplying the DTCS, VHA considers that the ACCC has no option but to declare all of Telstra's transmission capacity services until it can do so.

## 12. Conclusion

This inquiry and the upcoming consultation on a FAD provide the ACCC with a watershed opportunity to address the problems that have prevented the DTCS declaration promoting the LTIE in the manner the ACCC intended. At the core of those problems are two main issues:



- the mechanical application of a 'rule of thumb' test which fails to accurately measure the level of contestability on DTCS routes and has almost certainly led to uncompetitive markets becoming deregulated; and
- the use of a flawed benchmarking approach to the pricing of the DTCS which fails to assess the true cost of supplying the DTCS and allows Telstra to continue to exploit its market power by bundling services and engaging in pricing conduct which preserves its competitive advantage on contestable routes while deterring entry and efficient investment on monopoly (or near monopoly) routes.

The ACCC must begin to address these concerns now, as part of its current inquiry otherwise the benefits of declaration will be lost and consumers, particularly those in regional areas, will miss out.



## **Attachment 1: Market Clarity, Backhaul Fibre by Owner, 22 August 2013**

[c-i-c]