Response to Professor George Yarrow’s submissions to the ACCC
in the Domestic Mobile Roaming Enquiry 2016

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1. I provided an independent expert report under instruction from Vodafone Hutchison Australia (VHA) dated 1 December 2016 (which I refer to as my ‘original report’ or as ‘Feasey Report’), which has been submitted to the ACCC as part of representations made by VHA in connection with the current Domestic Mobile Roaming Enquiry. I have now been asked to respond to points raised in the report prepared by Professor George Yarrow, also dated 1 December 2016, in connection the same enquiry (‘1st Report’) and by his further note, dated 24 January 2017 (‘2nd Note’).

2. Professor Yarrow’s submissions are helpful both in explaining his position and in allowing me to clarify mine. Although there is much on which we agree, there are some key assumptions and key differences which explain why we come to fundamentally different conclusions on the question of whether the ACCC should declare domestic roaming. In this note I want to take the opportunity to explain those differences and indicate where and why I think Professor Yarrow is mistaken.

3. As Professor Yarrow notes, we both broadly agree about the competitive dynamics of the Australian mobile telecommunications market. We agree that firms compete, and consumers select network providers, by reference to a range of characteristics and that the prices of services and performance of the network, including coverage, are both important. We agree that a significant number of users in urban areas value coverage in regional Australia and that the prices charged by firms, and their investment decisions, will be influenced by this fact.

4. I also agree with Professor Yarrow’s suggestion that regulators should always proceed with caution and with regard to impact of their actions on both static and dynamic considerations. In other words, I agree that we need to consider the impact of any intervention on both the prices charged for services in the short term and the effect it may have on the incentives of firms to invest in their networks in the long term. I broadly agree that only if the benefits of intervention can be clearly shown to outweigh the potential costs should a regulator proceed.

5. Two preliminary points are worth noting at this stage before I examine the other assumptions which Professor Yarrow makes, and with which I disagree. The first is that just because we should pay close attention to dynamic considerations, such as the impact of regulation on network
investment, it does not follow that there is never a case for intervention by a regulator. We should not, in other words, ask today’s consumers to shoulder the burden of excessive or non-competitive prices just so that future generations may benefit from technological change. If the static benefits of a particular intervention, in terms of lower prices (and higher consumption and greater static efficiency), are sufficiently large, and the dynamic costs involved in obtaining them sufficiently small, then the LTIE will undoubtedly be improved by a move to what Professor Yarrow calls the Alternative Position. Whether or not this is the case cannot be determined by general theorising or by referring to past decisions taken in other industries in other countries. It requires careful examination of the evidence in this particular case.

6. Second, I take the LTIE in this context to refer to the interests of all Australians. The fact that one group of users may be less advantaged as a result of the intervention (or may benefit disproportionately as result of the Maintained Position) should not deter us if a much larger group of users stands to benefit, or benefits to a much greater degree. The interests of every group, including rural users, are important, but no one group is more important than any other in the eyes of the statute which the ACCC is required to apply in this enquiry. As Professor Yarrow notes, politicians often favour the interests of particular groups over others and intervene in markets in order to achieve what they consider to be socially desirable outcomes. Some groups are invariably better organised or incentivised to participate in an enquiry such as this than others. But the outcome of this enquiry should not be determined by who has the loudest voice or the most voluminous submissions. As I understand it, the ACCC has instead to weigh equally the interests of all Australians.

7. I now turn to consider what I take to be the three fundamental points of difference between myself and Professor Yarrow. These are, in brief:

   a. Professor Yarrow’s assumption that VHA and Optus constrain Telstra’s pricing behaviour across its entire portfolio of products such that all users pay ‘competitive prices’

   b. Professor Yarrow’s assumption that Telstra’s financial returns reflect only its network superiority and are not evidence of enduring market power and excessive prices and/or

   c. Professor Yarrow’s assumption that VHA and Optus could eventually replicate Telstra’s network coverage, or get close to doing so.

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1 For simplicity, both Professor Yarrow and I refer to ‘consumers’ or ‘users’. But we should not ignore the importance of having effective competition for business customers who value coverage, including the growing number of businesses who rely upon ‘Internet of Things’ applications to improve productivity. Geographic coverage is typically very important for such applications and the interests of Australians will be served by having objects, as well as people, connected to the networks of the future.
8. Before explaining how we differ, it is important to recognise that if all three of Professor Yarrow’s assumptions were correct I might also conclude that the current Australian mobile market (the so-called Maintained Position) was operating in a satisfactory (by which I mean adequately competitive) manner and that declaration was unnecessary. Like Professor Yarrow, I would expect that a firm offering superior network coverage and performance would be able to charge more for that service and so to sustain higher prices. I also have no difficulty with the notion that a competitive mobile market can work well despite each of the firms having quite different levels of network coverage under some conditions. I should therefore not be misunderstood as suggesting that all firms need to have the same coverage or the same prices, or that this is what the ACCC should be aiming for.

The scope of competition

9. Professor Yarrow and I broadly agree about how competition in mobile telecommunications markets ought to work in theory. Firms compete across a wide range of product characteristics, but price and coverage are the most relevant for our purposes. They will then employ ‘second degree price discrimination’ to address the needs of different groups of users, each of whom will have different preferences in relation to these dimensions of price and coverage. Some users will value coverage highly and be less concerned about price, some will value price highly and be unconcerned about coverage (beyond the location in which they live and work). Some may lie in between. The position of those living in rural areas where Telstra is the only provider is straightforward, since they currently do not have a choice of provider and so there is no trade off to be made. The interesting and important questions in this enquiry therefore relate to the choices faced by those living in urban areas.

10. Professor Yarrow is too quick in my view to assume that everybody who lives in urban areas must have competitive choices. His only basis for finding that the market is ‘vigorously competitive’ appears to be the observation that there a large number of MNOs and MVNOs. There are three MNOs and a number of MVNOs present in many urban areas, but it does not follow from this that every user living in those areas has a meaningful choice of provider. I am sure Professor Yarrow does not mean to suggest that we can draw conclusions about competitive dynamics from simply counting the number of firms, but I am afraid that in this instance he does not go beyond that.

11. I devoted a significant proportion of my original report to explaining how I viewed the competitive dynamics for both rural and for urban users. I identified groups of urban users who differ according to their relative valuation of coverage and price. I accepted that urban users who do not value coverage face a range of competitive choices from Telstra (or more likely the Telstra-hosted MVNOs through whom Telstra serves this segment of the market), VHA and
Optus (and the MVNOs those firms hosted as well). These users were likely to be paying what I refer to as ‘competitive prices’ in my first report\(^2\) and their needs were likely to be well served by existing arrangements as a result.

12. I then considered the case of urban users who value coverage greatly and who are prepared to pay higher prices to obtain it. Although they reside in an area with many providers, these users do not in fact have a meaningful choice of supplier, since only Telstra offers the level of coverage they require and neither VHA nor Optus represent an acceptable substitute. The question which then arises is what price we might expect this group of users to be paying. Would it still be a ‘competitive’ price or might Telstra be able to exploit the fact that these users are ‘captive’ to its network?

13. Whether the question matters at all will depend upon how numerous this group of users is and how strong their preference for coverage over price is. If the group is small and most urban users will happily give up coverage for price discounts, then we are unlikely to be unduly concerned. Professor Yarrow makes a similar point when discussing ‘natural monopoly’ by noting that small pockets of monopoly (aka the last shop in the village) will often be found in markets which we would otherwise characterise as being competitive\(^3\). However, I do not think that is the case here. I explained in my original report that Telstra has sustained a large market share in urban areas despite maintaining prices that appear substantially higher than those offered by VHA or Optus. That suggests to me that a significant proportion of the 95% of the population who are urban users, and a substantial proportion of Telstra’s share of that population, attach a very high value to coverage and would not regard VHA or Optus as viable substitutes. I will explain below why other features of Telstra’s behaviour also lend support to this conclusion.

14. Even if there are such ‘captive’ users, it might still be possible for Telstra to be subject to competitive constraints from VHA and Optus when serving them. This would be the case if what is often referred to the ‘chain of substitution’ were to operate. Although Professor Yarrow does not expand on this point, I take it to be implied by his references to the ‘interconnectedness’ of things\(^4\).

15. The ‘chain of substitution’ is what allows firms that have different characteristics that appeal to different groups of consumers to nonetheless influence each other’s behaviour. Some producers

\(^2\) Feasey Report, para 71  
\(^3\) 1\(^{st}\) Report, para 10.2  
\(^4\) Ibid, para 9.4
may compete across the entire range of products, as Telstra does in this case\(^5\), whilst others may compete for particular groups or segments, as VHA and Optus do. The fact that VHA and Optus do not compete directly with Telstra for users who value coverage very highly does not matter provided that there is a ‘chain of substitution’ operating between the various products. This ensures that if Telstra sought to raise prices above competitive levels for the products for which it faced no direct competitors, a significant number of users of that product would switch to a product where Telstra did face direct competition. In our case, users who value coverage would switch to a product which offered less coverage. If Telstra then tried to raise the price of that product, some users would switch to a product with even less coverage. And so it continues along the ‘chain’ until we reach a product for which Telstra faces direct competition and for which it cannot raise the price above the competitive level. On this theory, and provided enough users will switch in each case, Telstra’s prices to urban users who value coverage highly will always be constrained by VHA and Optus even though they do not themselves offer a viable product to that particular group of users.

16. This all works well provided there are sufficient users distributed along each link of the chain and provided enough of them will switch away to another product in the chain if Telstra attempts to raise its prices above the competitive level. It is clear from reading Professor Yarrow’s report, and even more evident in Telstra’s main submission, that they envisage a world in which users are relatively evenly distributed along the chain. Thus, both Professor Yarrow and Telstra seem to think that it is open to VHA and Optus to add coverage to their networks little by little, and to capture a share of another group of customers each time they do (those clustered around the next ‘link’ in the ‘chain’ who value coverage a bit more and price a bit less than those they already serve). They seem to be suggesting that an incremental increase in coverage by either VHA or Optus will result in those firms gaining some commensurate increase in market share and that there is a simple linear correlation between coverage and market share.

17. This is where I disagree with Professor Yarrow. I do not think the ‘chain of substitution’ operates so as to protect these urban users who are ‘captive’ to Telstra, nor to allow VHA or Optus to expand their coverage in the way that is supposed, as I explain later in this note. Instead, I think Telstra is able to sustain a price that is above the competitive level in respect of this group of users, and I think this group of users is quite large. It is not clear whether this is what Professor Yarrow has in mind when he refers to the risk that markets can ‘bifurcate’ and ‘tip’\(^6\), but markets can and do bifurcate when the chain of substitution breaks down, and I believe it has in this case.

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\(^5\) I explained in my original report how Telstra uses MVNO brands to serve some lower price segments, see Feasey Report para 72
\(^6\) 1st Report, para 5.5
When that happens groups of users who face competitive prices can co-exist alongside groups of
users who do not, and insurmountable barriers arise to prevent competitors from moving along the
chain and competing in some parts of the market.

18. It is not easy to determine whether the Australian mobile market has bifurcated in the way I
suggest, but I think there is strong evidence to suggest it has. Ideally, we would know what the
‘competitive price’ should be for those that value coverage very highly and compare that to the
price actually charged by Telstra. That is not feasible given the lack of an appropriate comparator.
Alternatively, we would survey groups of users or examine their behaviour in response to changes
in coverage or price or both, in order to obtain a picture about how they might be distributed
along the various links in the chain. I would expect Telstra to have a good understanding of how
different groups of urban users view the trade off between coverage and price, and think that
information would be of assistance to the ACCC.

19. In the absence of this, I turn to other evidence and the second point of disagreement with
Professor Yarrow.

Telstra’s financial returns

20. Evidence of Telstra’s ability to sustain prices to some urban users which are well above
‘competitive levels’ is likely to be found in Telstra’s financial returns. As Professor Yarrow notes,
the fact that Telstra charges higher prices or earns higher variable margins than either VHA or
Optus is not conclusive, since Telstra offers a service which involves superior coverage and
which has higher fixed (and variable) costs of supply. Telstra’s prices can certainly be higher than
VHA and Optus whilst still being constrained by them.

21. Moreover, the fact that Telstra earns higher profits than VHA and Optus, taking into account both
its fixed and variable costs, would not necessarily give rise to concern if those profits were
transitory and served to provide signals and incentives for VHA and Optus to expand their own
product portfolio to compete for a share of them and, crucially, provided VHA and Optus were in
a position to do so. I thus have no difficulty with market leaders earning high profits as a result of
what Professor Yarrow calls ‘competitive superiority’ or ‘differential efficiency’. Professor
Yarrow seems rather uninterested in Telstra’s financial performance. Perhaps this is because he is
more interested in what he calls the ‘structure’ of prices than in their level\(^7\). I take this to be
because he is very attracted by what he calls the ‘price flattening’ qualities of existing

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\(^7\) 2nd Note, para 14 and 16
arrangements and so his primary concern is that declaration might disrupt or ‘perturb’ them, leading to rural users paying higher prices for mobile service than they do today. As I explain below, I think he need have no such fears, and that there is no prospect of the declaration resulting in a geographic deaveraging of prices such that rural users would be made to pay more than urban users. But even if this were the case, it does not follow that structure is all that matters and that we can disregard the level of prices which users pay.

22. It is self-evidently in the LTIE if the same level of coverage could be supplied at a lower price than the price charged by Telstra today. Indeed, I think this is the central question which the ACCC should be asking itself in this enquiry.

23. In contrast, I find that Professor Yarrow’s concern for structure over level leads him to be rather dismissive of price competition in general. He says his ‘general rule of thumb is that, if price undercutting can be quickly matched by price responses from others – i.e. if the price offers only transitory competitive advantage- do not expect much price competition in a market’\(^8\). I am not sure whether his client, who devote a substantial part of their submission arguing that competition of this kind has driven prices down in the Australian mobile market and that users have benefited greatly as a result, would necessarily agree with him. I certainly would not.

24. A more forensic analysis of Telstra’s financial returns would need to be undertaken to resolve these issues. Telstra would be in a position to assist the ACCC on this point but its submission is uninformative. It simply reports Telstra’s EBITDA margin for the mobile business, which tells us nothing about their returns on capital or profits, and a Net Profit After Tax figure which is for the entire business rather than for mobile business. They also compare these figures against equivalent figures for firms in other industries\(^9\), the relevance of which is lost on me. In my view, the ACCC ought to require Telstra to provide much more detail as to the profitability, properly measured, of its mobile operations over a significant period of time. In doing so, great care must be taken to ensure that costs which are common between Telstra’s fixed and mobile businesses are allocated in a transparent and appropriate manner. This would allow the ACCC itself to form a clearer view as to whether Telstra’s current prices are consistent with competitive returns.

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8 1st Report, para 11.26. It is not clear to me whether Professor Yarrow is suggesting that firms will not compete on price if reductions can be quickly matched and that they will instead engage in what is sometimes called ‘conscious parallelism’ on pricing. This is a slightly odd position if it is taken to mean that prices will fall faster and further in markets where price reductions are difficult to match than in markets where they can be matched quickly. My own experience of mobile markets is that price changes can be matched quickly, and that prices fall quickly. That is why the challenge in mobile has always been to find non-price (quality) advantages which are harder or take longer to replicate.

9 Telstra submission, p.75
25. My own view remains that what appear to be comparatively high and sustained levels of profit are much more likely to be evidence of the exercise of market power than being evidence of some temporary coverage advantage which VHA or Optus could be expected to eliminate quickly or at any point in future. It is important to note that both conditions need to be met. I would be less concerned that a break in the chain of substitution meant that VHA and Optus did not constrain some of Telstra’s prices today if I thought VHA and Optus could expand their own product portfolios (by extending their own network coverage) and serve the needs of those users directly tomorrow. In such a case, Professor Yarrow would be right to argue that Telstra’s ‘high gearing’ is needed to promote competition in coverage and to realise the dynamic benefits of investment to which he attaches so much importance. But if VHA and Optus cannot replicate Telstra’s network, or get anywhere near to doing so, as I believe, then Telstra’s profits serve no purpose other than to reward its market power.

26. I consider the evidence as to whether Telstra’s network can be replicated in a moment, but before doing so want to make two comments about the likely magnitude of the rents or profits which Telstra derives from its captive users, both of which are suggested by other evidence which Telstra has submitted to the ACCC.

27. The first relevant piece of evidence is the modelling undertaken by Ovum for Telstra. I understand it to suggest that Optus would be able to replicate [CIC begins][CIC ends] of Telstra’s rural coverage (i.e. Telstra-only sites) if Optus were to gain [CIC begins][CIC ends] percentage points of retail revenue market share as a result, charging a [CIC begins][CIC ends] discount to the prices charged by Telstra in the process. Ovum explain that this represents revenues of [CIC begins][CIC ends].

28. I assume that under these conditions Ovum are saying that Optus would recover its costs, including an appropriate return on its capital, which is akin to what we might consider a firm would achieve under competitive conditions. This is, in other words, the minimum return which Optus needs to earn in order to make the investment. The conclusion which Telstra and Ovum seem to want us to draw from this is that [CIC begins][CIC ends] is a very modest requirement, and that it is perfectly feasible for Optus to replicate a substantial part of Telstra’s network. It might be thought surprising that they have not already done so.

29. Ovum do not consider why or whether having only [CIC begins][CIC ends] of Telstra’s regional coverage would be enough to persuade even users representing [CIC begins][CIC ends] of market revenues to switch away from Telstra and move to Optus. It may well be that Optus would need...
to replicate much more than [CIC begins][CIC ends] of the Telstra network before it could hope to attract a significant number of additional users in such a highly bifurcated market. I therefore adopt Ovum’s model to illustrate the point I want to make without necessarily agreeing with the underlying assumptions.

30. Telstra’s latest financial results for the 6 months to 31 December 2016 report mobile revenues of around $10bn p.a.\textsuperscript{11} Using the total mobile market revenue implied by the Ovum model, Telstra has a revenue market share of around [CIC begins][CIC ends], although I am advised by VHA that this may be something of an overstatement and that the basis on which Telstra and Ovum derive their revenue figures may differ. I understand a figure of [CIC begins][CIC ends] is closer to the mark, and I make that assumption in what follows\textsuperscript{12}. I do not know the exact split of revenue market share between VHA and Optus but I understand a reasonable assumption would be that Optus’ mobile revenue market share is around [CIC begins][CIC ends], leaving with VHA with [CIC begins][CIC ends].

31. In such a case the Ovum model tells me that a firm would require a national revenue market share that is [CIC begins][CIC ends] percentage points higher than Optus’ current share of [CIC begins][CIC ends], in order to finance coverage at [CIC begins][CIC ends] of Telstra’s regional network and make normal economic returns\textsuperscript{13}.

32. Unfortunately, Ovum do not disclose what additional revenue market share Optus would have to acquire to fully replicate the Telstra network (although no doubt the ACCC could ask them), so I need to make some further assumptions.

33. How much might this last [CIC begins][CIC ends] cost? The additional revenue market share required to fund the last [CIC begins][CIC ends] will need to be more than [CIC begins][CIC ends], since costs will be non-linear and will climb sharply as network coverage expands into the most remote rural areas that represent a significant proportion of the last [CIC begins][CIC ends]. Table 3 of Mr Joice’s Witness Statement indicates that a ‘rural’ site involves average capex of around [CIC begins][CIC ends], which compares to around [CIC begins][CIC ends] for a ‘regional’ site, although operating costs are a little lower in the former case\textsuperscript{14}. That shows that costs per site rise as the network extends, although not by a very great deal.

\textsuperscript{12} [CIC begins][CIC ends] equivalent to ‘excess returns’ of over $5 billion p.a. I consider this figure to be implausibly high.
\textsuperscript{13} Note that this implies that Optus currently earns ‘normal’ returns on its existing network from its existing market share. This seems reasonable, since Optus faces competition from Telstra and MVNOs across its entire network, and from VHA across most of it, but I have not sought to validate it.
\textsuperscript{14} R Joice Witness Statement, p. 11
34. Let us suppose that the cost to cover the last [CIC begins][CIC ends] were to be 2 times greater than the cost required to support the first [CIC begins][CIC ends] of the Telstra only coverage. This is in excess of anything implied by Mr Joice or anything I find in the Ovum report, so may overstate Telstra’s coverage costs. In such a case, the Ovum model tells us that Optus would need to add another [CIC begins][CIC ends] and hold a total retail revenue market share of around [CIC begins][CIC ends] in order to earn a ‘competitive’ return across a network which fully matched Telstra’s for coverage.

35. Recall that Telstra’s actual retail revenue market share is closer to [CIC begins][CIC ends] today. The difference – [CIC begins][CIC ends] percentage points of revenue market share or at least $2.1bn of annual revenues – are revenues which the Ovum model suggests Telstra does not need to earn in order to cover its network costs. They therefore provide an indication of the magnitude of ‘excess returns’ which Telstra derives from its market power.

36. The second piece of evidence relates to those commitments to invest further in its rural network, which are made by Telstra as part of its submission. Telstra says it will invest a further $350m to expand coverage and capacity and another $100-200m in what it calls ‘co-investment’ projects over a unspecified time period, both of which are ‘contingent on the current regulatory settings remaining in place’. At first glance, Telstra’s commitment to extending coverage in areas where there is little prospect of replication by either VHA or Optus at any time in the foreseeable future is odd. The number of rural users who would be added as subscribers will be trivial, so Telstra would have us believe that these investments are being driven by competition from VHA and Optus for urban users.

37. I explained in my original report how I think urban users are likely to assess coverage claims and how those who value coverage highly are likely to gravitate towards the network that offers the best overall geographic coverage (and hence the best prospect of obtaining a signal wherever and whenever they might need one). As Professor Yarrow notes, competition is undertaken on the basis of relative performance, as assessed by customers, and Telstra’s claims in its marketing and advertising to be ‘the network without equal’ reflect that. I also noted that Telstra already has a massive geographic coverage advantage over VHA and Optus, being nearly 1.8 million km².

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15 Para 4.33 of the Ovum report refers to per site costs of between [CIC begins][CIC ends], but it is not clear to me which parts of the network these relate to.

16 These numbers obviously need to be treated with caution for the reasons explained above. The ACCC could ask Telstra and Ovum to examine my assumptions and to provide better ones if they disagree with them.

17 Telstra p.9

18 Feasey Report, para 20-21

19 2nd Note, para 17

20 Feasey Report, para 20-22
over VHA and around 1.4 million km² over Optus. I very much doubt whether the planned investments by VHA or Optus which Telstra cites in its submission, or to which Optus refer in their submission, would come remotely close to eliminating or even substantially closing that gap. I think we can be clear that Telstra will continue to be the ‘network without equal’ irrespective of whether it invests the $350m or not.

38. So why is Telstra continuing to expand its network when, as Professor Yarrow notes, it is more common for businesses with substantial market power to restrict supply? It cannot seriously be claimed that it is because Telstra fear being overtaken by Optus or VHA in the coverage stakes. Competition in coverage can develop in this ‘leapfrogging’ pattern, with one firm first gaining and advantage and then another, or with one firm narrowing the gap sufficiently to force the other to pull away again. But I think it is stretching credibility to suggest that this is what we see in the Australian market today, or are likely to see in the future.

39. I am led to the conclusion that Telstra’s commitments are not being driven by competitive pressures at all. Indeed, it is not clear to me that very many of the investments made by Telstra in regional Australia in recent years have been driven by purely commercial considerations. Many of them seem to involve participation in Government Black Spots programme, where we might think of Telstra being forced to bid to do things which it would not otherwise choose to do absent Government intervention. It would be interesting to know how much capital Telstra has invested in remote rural areas outside of these various Government projects, since this would give us a better indication of what Telstra has chosen to do unilaterally. I do not have these figures, but again the ACCC could no doubt ask Telstra for them.

40. The fact that Telstra’s management apparently feel they can withdraw investment in response to regulatory action by the ACCC but apparently without regard to what its competitors might do strengthens my view. So does the fact that they feel able to make these statements without regard to the wholesale pricing arrangements which would determine whether or not such investments were profitable to make. I would therefore interpret Telstra’s very public commitments (and implicit threats) as being payments that it is prepared to make simply in order to avoid declaration and thereby to preserve its market power. In my experience, it is quite common for firms to act in this way, and to do so in an attempt to put a value on the ‘cost’ which might be incurred if the regulator were to intervene (i.e. to influence the framing of the Alternative Position).

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21 2nd Note, para 17
22 I am also aware there is a debate about the extent to which Telstra may have used income from Universal Service Fund arrangements to subsidise regional coverage.
41. Irrespective of whether Telstra’s commitments are genuine or whether those investments would be efficient, Telstra would not make them unless they feared a loss of profits from declaration that was greater than the commitment being made. Thus, I consider that the $450-550 million quoted by Telstra provide the ACCC with a helpful lower bound estimate of the profits which Telstra itself expects to extract from its captive customers through the exercise of market power. We have already seen that the Ovum model suggests that Telstra’s excess returns are likely to be very substantially greater than that. Offering the spend $450-550 million over a 3 to 5 year period (i.e. $100-200m p.a.) looks to be a good investment for Telstra to make in an attempt to preserve its current market position, and sustain returns which amount to many times that.

Replicability of Telstra’s network

42. I have already explained that Telstra’s profits would be of less concern if they were temporary in nature and served to induce VHA and Optus to invest in their own networks in order to capture a share of them. VHA and Optus ought to have every incentive to do so, since they would then be able to compete for a group of customers who value coverage highly, are willing to pay for it and appear to be a significant source of Telstra’s profits. Yet we have been waiting at least a decade for Optus and VHA to narrow the gap in coverage with Telstra, without any evidence of their having any prospect of being able to do so. Is it, as Professor Yarrow and Telstra might have us suppose, simply a question of being patient and waiting for the moment to arrive? Or is it, as Telstra might otherwise claim, simply incompetence on the part of Telstra’s rivals that means they continue to enjoy such an advantage today? In my view it is clearly neither.

43. The first point is that we can, I think, dispense with any notion that VHA or Optus would be able to match Telstra’s coverage by means of coming to some commercial arrangement to roam on Telstra’s network. That would contradict Telstra’s claim in its submission that it invests in order to gain ‘first mover advantage’ and that it would not wish to give this away. I devoted a considerable part of my original report to the question of whether Telstra could be expected to grant access to its network on commercial terms in the absence of regulation, so it is helpful to have Telstra confirm that it would not. In the absence of declaration (the Maintained Position), the only way VHA and Optus could hope to match Telstra’s coverage would be to invest in their own networks and replicate Telstra’s network footprint.

44. This point is also relevant to an earlier point. Both Telstra and Professor Yarrow seek to persuade us that the MVNOs which Telstra hosts on its network are a source of ‘vigorous competition’. But Telstra also confirms in its submission that it restricts the coverage available to these Telstra-
hosted MVNOs to only 1.6 km² of its overall network, having limited them to only 1.3km² until recently. This is entirely consistent with Telstra’s claim that it needs to capture any ‘first mover advantage’ from its network investments for itself and to remain ‘the network without equal’. It does this by reserving access to the remaining 800,000 km² of geographic coverage for its own retail operations. It is also entirely consistent with my view that even very small differences in population coverage will not be sufficient to overcome perceptions of network inferiority which the large difference in geographic coverage sustains, and so it is the gaps in geographic coverage that really matter here. Given this, I conclude that whilst the Telstra-hosted MVNOs may provide competition for those users who do not value coverage highly, they no more constrain Telstra’s pricing for urban users who value coverage than VHA or Optus do.

45. With domestic roaming on commercial terms unlikely to be available in the Alternative Position, I return to the prospects of VHA or Optus being able to close the geographic coverage gap sufficiently to compete for the captive customers. It is, as I noted at the outset, not necessary for VHA or Optus to fully match Telstra’s coverage to offer at least some of these users a viable alternative, since some will be prepared to exchange some loss in coverage for lower prices and if there are enough of these, then the chain of substitution will operate. Equally, however, it is not the case that any addition of coverage by VHA or Optus will be sufficient to have this effect (I noted earlier that the proposed by Ovum might not be enough). The gap in coverage will need to be sufficiently narrow for a sufficient number of users to be prepared to consider VHA or Optus as a viable alternative.

46. As I am sure Professor Yarrow would remind us, nobody can know exactly when this point might be reached. But if it were as easy as Ovum imply – adding only percentage points of revenue market share to match of Telstra’s regional coverage – then I think we might reasonably have expected VHA or Optus to have attempted it at some point over the past 10 years. I would expect to see VHA and Optus investing heavily in coverage and gaining retail market share from Telstra. In fact, as the ACCC’s Discussion Paper shows, VHA and Optus have both been losing market share over the past five years. In the world that Telstra and Professor Yarrow inhabit, such competitive losses ought to push these firms to invest heavily in improving their coverage. But, as I note below, that does not appear to be what they have done. Telstra’s submission identifies investments by Optus in its regional

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23 Telstra submission, p.18
24 This point means that parts of Telstra’s submission, such as Table 3 on p.16, are misleading and wrong. Many of the 98.8% of customers that Telstra claims have a choice of provider would value coverage highly and would not regard MVNOs as a credible alternative to Telstra in practice. Again, simply counting the number of providers tells us little or nothing about competitive dynamics.
25 ACCC Discussion Paper, p.22-23
networks of no more than $50m and by VHA of little more than $30m\textsuperscript{26}. Thus, I find strong competitive incentive but no competitive ability. Something is wrong with the market.

47. To understand what is wrong, I think it is useful to return to Telstra’s insistence on the importance of ‘first mover’ advantage to explain why Telstra’s network can never be replicated. In doing so, I ignore here and throughout this note the important issue of those parts of the Telstra network that have benefited from public subsidy which would not, presumably, be available to VHA or Optus if they sought to replicate them. This is an important issue, particularly if the Telstra coverage that is provided by means of public subsidy is a significant proportion of the regional coverage advantage it enjoys (I do not know whether this is the case or not, but assume the ACCC can determine). But that is not the point I want to make here.

48. In the rest of the privately financed network, Telstra currently enjoys what I called a ‘monopoly’ and what they might refer to as ‘first mover advantage’. One consequence of this, in my view, is that Telstra obtains a degree of market power which is reflected in the higher prices it is able to charge. These prices would be expected to fall, perhaps substantially, if VHA and Optus were both to match Telstra’s coverage and/or the group of urban customers that were prepared to pay for this coverage benefit would now have to be divided amongst the three firms rather than all being served by Telstra.

49. The lower revenues that would inevitably follow for each operator (relative to a position where one firm enjoyed a monopoly in coverage) would be bad news for Telstra. But Telstra, as the ‘first mover’, cannot do much about it since it has already sunk its investment in the network. Optus and VHA are in a different position. They have to decide whether or not to invest at all, knowing that if they do competition will increase, prices will fall and they will be sharing the market with Telstra and with each other. They will only go ahead if, despite this, they still believe they can make a return on the relevant network investments. This explains why a ‘second mover’ will assess the investment decision in a different way to the ‘first mover’, particularly if the former thinks that the latter could cut prices to meet competition\textsuperscript{27}. The ‘third mover’ will then

\textsuperscript{26} Telstra submission, p.25. Optus’ own submission identifies various ‘rural’ investments it has made, but which seem to amount to no more than $25m, Optus submission, p. 5-6

\textsuperscript{27} It is important to note that I am not suggesting that if Telstra’s presence deters investment by second and third movers, then Telstra is thereby engaging in anti-competitive conduct or that such investments should be prohibited. Telstra’s investment is better than no investment at all, as Professor Yarrow notes. But the Alternative Position in this enquiry is not a position in which there is no coverage at all, but a position in which the ACCC declares domestic roaming. If Optus and VHA can never replicate Telstra’s current coverage (or get anywhere near to doing so) under the Maintained Position, then the Alternative Position is very likely to be in the LTIE.
face a different set of calculations again, and even more perilous prospects than the second and first movers\textsuperscript{28}.

50. I think this helps to explain why Telstra’s coverage will not be replicated by VHA and Optus, particularly if users are clustered at extreme ends of the chain of substitution such that VHA and Optus would need to make very large network investments in order to be in a position to switch large groups of urban users. The fact that neither VHA nor Optus have been able to gain market share by making incremental investments to replicate Telstra’s coverage in recent years provides further evidence, in my view, of the break in the chain of substitution and the bifurcated nature of the Australian mobile market which I explained earlier in this note.

51. The point can be illustrated using the Ovum study. As explained earlier, Optus is assumed to be able to sustain investments representing [CIC begins][CIC ends] of the Telstra regional network if it discounts prices by [CIC begins][CIC ends] (relative to Telstra) and captures an additional [CIC begins][CIC ends] percentage points of revenue market share in the process. Whether they are right or not, these numbers illustrate the economics of the ‘second mover’, being the price discounts that need to be offered and market share (in terms of revenue, but for which there will be a corresponding share of subscribers or connections) that needs to be acquired by a firm entering an area where Telstra is already the ‘first mover’\textsuperscript{29}.

52. Telstra itself would have incurred the same costs and required the same revenues as Optus to fund its investment. But it would have been able to sustain higher prices than Optus, reflecting its ‘competitive superiority’ over both Optus and VHA (whereas Optus would enjoy ‘competitive superiority’ only over VHA). Telstra would have needed to gain a smaller additional subscriber market share - perhaps 1.5 percentage points in the Ovum example - than Optus to generate the same revenues.

53. Now consider the position of VHA. They face the same costs as both Telstra and Optus and need to earn the same revenues to fund the investment. But as the ‘third mover’ they have no ‘competitive superiority’ over either Optus or Telstra. VHA would now need to discount below Optus to gain share – perhaps cutting prices by [CIC begins][CIC ends] relative to Telstra. With

\textsuperscript{28} I made this point, but in less detail, at para 45 of Feasey Report.

\textsuperscript{29} To simplify what follows, I assume that Optus incurs the same network costs as Telstra in the process. I noted in my original report (para 45) that Telstra is likely to have significant cost advantages, deriving from economies of scope and scale, over both Optus and VHA. The position is also complicated by tower sharing, which might reduce the costs for both the second and the first mover (and further still with a third mover), whilst Telstra may also recoup some of the lost mobile retail revenues from wholesale charges it makes to Optus or VHA for transmission services. How this all plays out depends on the sharing arrangements between the firms but does not alter the basic point I am making here.
lower prices, VHA would need to gain an even larger additional *subscriber* market share than Optus – to generate enough revenues to sustain the investment. The challenge and risk VHA faces in making the investment (and in the subscriber market shares it must win if it is to finance them) is therefore greater than Optus and much greater than Telstra.

54. This explains why a network investment which might be feasible for the ‘first mover’ may still not be remotely feasible for a second, much less a third, mover, both of whom will need to assume they can acquire a much larger share of customers to finance it, with correspondingly higher risks of failure. If those customers are also unevenly distributed along the ‘chain’ in terms of their relative valuation of coverage, as I suggest, then the need to acquire a much larger share of them may prove even more challenging would be the case if the correlation between coverage and market share were linear.

55. It might be argued that it was also open to Optus or to VHA to be the first mover in the past and to put Telstra in the position of facing the risks associated with being a second or third mover. I do not know whether this is factually correct, but it is in any event beside the point. The issue at hand for the ACCC is simply whether Telstra’s first mover coverage advantage, viewed in conjunction with the conditions which prevail in the Australian mobile market today, serve to prevent either Optus or VHA from being able to replicate it in the way that the Ovum modelling suggests. I think all the evidence shows that it does.

56. In this part of my report I have addressed what I think are the three fundamental points of disagreement between Professor Yarrow and myself. He thinks that all urban users face competitive choices, since there are many providers of service in urban areas, and/or the chain of substitution ensures that competition constrains Telstra even when it faces no competitors who can offer the same or similar products. This leads him to assume that Telstra’s profits are simply evidence of its network superiority, to be competed away. He further implies (although he does not examine this point in any detail) that one way they can be competed for is for VHA and Optus to expand their own network coverage and that, in doing so, they face the same economics and same incentives as Telstra faced when making its investments.

57. I disagree with all these assumptions. I think there is good evidence to suggest that the chain of substitution does not protect a significant group of urban users from paying more for their Telstra service than they ought or need to. Accordingly, I think Telstra’s profits are evidence of market power and that this market power is not transitory in nature. I find that other parts of Telstra’s submissions confirm this view, particularly the modelling by Ovum and Telstra’s own claims that it would unilaterally withhold up to $550m or more of investment in the event of declaration. I also find no evidence to support a belief that VHA or Optus would or could bridge the coverage
gap with Telstra or that customers who are captive to Telstra today will be presented with a credible choice of network provider in the future. There is, in other words, clear evidence to show that the benefits of declaration exceed any potential costs by a margin of appreciation which far exceeds anything even Professor Yarrow would require.

The impact of declaration

58. I want now to turn to consider the likely costs and benefits arising from declaration in more detail, since this is another issue on which Professor Yarrow and I disagree.

59. I should start by noting that I agree with Professor Yarrow that existing arrangements appear to serve users who live in rural areas well and that they benefit from coverage which is subsidised by urban users who value it and who contribute a lot towards it. But I disagree with the view that existing arrangements are the best that can possibly be attained, even for these rural users, or that the LTIE cannot thereby be improved upon.

60. The first point here is that the price rural users pay for their mobile service will be determined by the price which the much larger group of urban users pay. Note that in what follows I use the term ‘price’ in the conventional sense, as being the actual price paid for service rather than being anything which also tries to capture quality (i.e. network coverage and performance), which is something I turn to later. In Professor Yarrow’s view, since urban users are assumed to pay competitive prices and since mobile markets provide opportunities for what he calls ‘inter-area arbitrage’[^30], rural users will obtain access to services on competitive terms as well, even if Telstra is their only choice of supplier. I should note here that there is nothing unusual about these pricing inter-dependencies in mobile markets, and certainly nothing unique to the Australian market.

61. Professor Yarrow seems worried that one consequence of declaration could be that Australian operators would begin to charge different prices for services provided to those living in rural areas as compared to those living in urban areas, the implication being that prices would rise in rural areas to reflect the higher costs of supply. I strongly disagree and think that, if anything, the opposite is the case. Inter-area arbitrage means, as Professor Yarrow explains in his footnote (13), that if an operator attempted to impose a higher subscription charge on a user who lived in a rural area they would simply go to town and buy their subscription there. The only way to avoid this would be for the Australian operators to collectively impose vetting of buyers and require them to provide evidence of where they live. I am not aware of any mobile market in the world where

[^30]: 1st Report para 11.18
operators do this for the purposes of applying geographically differentiated prices (proof of identity is sometimes required for national security and other reasons) and note that there has been no suggestion from Telstra in this enquiry that they would even contemplate this in the event of declaration. Alternatively, I suppose that the operators could abandon existing subscription based models altogether and impose usage based charges which would differ depending upon which part of the network the usage occurred in, with higher charges in rural area and lower in urban. Again, I find nothing to suggest that this happens anywhere else in the world, is likely in this case, or that Telstra has indicated that this is what it would do.

62. Professor Yarrow’s concern about ‘economic separation’ between his low density and high density areas arises from his initial observations that, in most competitive markets, prices can be expected to align with costs and that, in this market, costs are significantly higher in the less dense or rural areas and significantly lower in the high density or urban areas. We might therefore expect prices to be higher in rural areas but, he explains, ‘demand complementarity’ ensures this is not the case and that uniform prices prevail instead. He then worries that any reduction in what he calls ‘out of area’ competitive pressures’ will threaten this arrangement (although he might equally have worried about the increase in competition in the low cost urban areas threatening the subsidy that supports uniform pricing).

63. I think Professor Yarrow is wrong on two counts. First, as I explained in my original report, a declaration would actually make VHA and Optus more, not less, competitive in terms of offering services ‘out of area’, by which I mean offering regional coverage to those living in urban areas. I would expect this to reduce, not increase, the prospect of ‘economic separation’ in the market. Second, the impact of the declaration on retail pricing will depend upon the structure of the wholesale prices that are charged, which I also discussed at length in my original report. I proposed various wholesale pricing structures which would address Professor Yarrow’s concerns. I would therefore attach no weight to concerns that rural users would pay prices that differ from urban dwellers as a result of declaration and nor have I encountered a mobile market where this is the case.

64. It follows that the prices paid by rural users will continue to be determined by the prices paid by urban dwellers. The next, and to my mind crucial, question is whether those prices are likely to be higher or lower as a result of declaration. Answering this question is not entirely straightforward.

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31 Ibid, para 7.10
32 Ibid, para 11.19
33 Professor Yarrow seems to mix up price and quality effects when discussing this point at para 11.20 and 11.21 in an attempt to persuade us that, whatever the precise mechanism, users in his LD areas will be worse off. It is far from being the clearest part of what is otherwise a well written report.
because it will depend upon the wholesale pricing arrangements which are adopted, since these will constrain the retail prices which VHA and Optus are able to charge, which will in turn influence the prices which Telstra is able to sustain. There are various approaches to wholesale pricing, all of which I discussed at length in my original report. Professor Yarrow either does not recognise the relevance of wholesale pricing assumptions to his conclusions, which I very much doubt, or he is suggesting that what he calls ‘cost of service regulation’ will produce the outcomes he postulates however it might be applied\(^{34}\). He seems to ignore the prospect that the ACCC might be willing or able to adopt other forms of wholesale pricing would alleviate his concerns. This is odd given that much of the regulatory debate, to which he has contributed significantly, over the past 30 or so years has been concerned with addressing precisely these kinds of challenges.

65. I think we can be confident that a declaration will reduce prices under a wide range of conceivable wholesale pricing arrangements provided we assume that Telstra’s current prices for urban users who value coverage highly are above the competitive level and hence above the level that would be required to sustain the ‘cost of service’. I explained in the previous section and in my original report why I think this is the case, and it follows that I think the competition from VHA and Optus for this group of ‘captive customers’ that would be enabled by declaration would have the effect of reducing the prices they pay, and potentially reducing them substantially\(^{35}\).

66. I am not sure Professor Yarrow would disagree with me thus far, although I am sure he would say that current prices are already settled at competitive levels. He himself recognises that the declaration decision ‘can be viewed as a trade off between infrastructure competition and service-based competition’\(^{36}\). I agree, if a ‘trade off’ is taken to mean that an action may simultaneously improve matters in one aspect and make them worse in another. Since Professor Yarrow spends much of his report explaining why declaration will dampen network investment, he must think declaration will reduce revenues and, hence, prices. If not, he needs to explain why an increase in the prices that a firm charges and the returns it makes on its investments would have the effect of weakening (rather than strengthening) its incentive to invest.

67. I find Professor Yarrow rather elusive on the question of prices generally. He says variously:

   a. ‘whether or not the average level of prices will increase or decrease is a matter that is much more difficult to determine’ (para 11.23)

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\(^{34}\) 1\(^{st}\) Report, para 15.6  
\(^{35}\) I suggested earlier in this note (see para 30) that Ovum might be able to assist the ACCC in determining how much prices would fall if Telstra were to recover its network costs and no more, based on current market shares.  
\(^{36}\) 1\(^{st}\) Report, para 15.10
b. ‘Telstra’s prices might decline…..because without its coverage advantage, some of its customers could be expected to switch to other providers who offer lower prices and now offer greater coverage’ (para 11.24)

c. ‘quality of service would also tend to decline due to reduced infrastructure investment…the overall implications for the quality-adjusted prices are therefore unclear’ (para 11.24)

d. ‘End users [in LD areas] would have a larger range of service providers from which to choose, bringing greater variety in tariffs, and there might be some increase in efficiency in the use of existing assets’ (para 15.10)

68. The second of these quotations is the closest to my position. The reasoning is simple. Declaration will allow VHA and Optus to compete for a group of urban users who value coverage and who would not previously have regarded VHA and Optus as credible substitutes for Telstra. Unless wholesale prices were set in a very perverse way, more competition is likely to result in lower retail prices, not least because it would make little sense for VHA and Optus to buy domestic roaming from Telstra (or for VHA to participate so actively in this enquiry) if they had no intention of using it to acquire customers. Acquiring market share is likely to require VHA and Optus to discount against Telstra’s price and for Telstra to respond in kind (this is the kind of price competition to which, as I noted earlier, Professor Yarrow seems to attach relatively little importance but which I think is critical in this enquiry and to the LTIE in this case). The prices paid by urban users who do not value coverage would be likely to remain undisturbed, since declaration has no impact on competition for this group of users (I explained at some length in my original report why they would not see their prices rising and why competition would ensure that they could not be forced into buying more coverage than they required). However, the prices paid by urban users who value coverage are also the prices that are likely to determine the prices paid by rural users for their service, since both require the same coverage (i.e. the ‘geographic differentials in quality’ to which Professor Yarrow refers to do not apply for these groups of users, even if they do apply as between rural users and urban users who do not value coverage)

It follows that if prices for urban users who value coverage fall as a result of declaration, then so too will the prices paid by rural users.

37 Feasey Report, para 84. I note that Professor Yarrow did not raise this as a potential concern in his report.

38 1st Report para 11.21

39 This is a simplification of the more complex set of pricing effects which I explained in my original report, see Feasey Report paras 136-145. I note that prices paid by urban users who do not value coverage might also fall if prices for those who do value coverage fall, due to the ‘chain of substitution’ effect referred to earlier. But I attach little significance to this because (a) I consider that current levels of competition for this group of users is
69. I come to this conclusion whilst recognising, as I noted in my original report, that some urban users may decide to pay more for their mobile service than before. These will be users who value coverage but are not prepared to pay the prices currently demanded by Telstra. They are currently forced to forgo coverage and buy a lower price product from VHA or Optus if they live in urban areas, or may have no mobile service at all if they live in areas where Telstra is the only provider. If declaration reduces the price of the higher coverage products, some of these users may be willing to trade up. They may pay more for higher coverage than they pay today for lower coverage, but they will be better off and the LTIE will be improved.

70. Having established that prices payable by the majority of urban (and all rural users) are likely to fall as a result of declaration, we are left with the question of whether these static benefits are nonetheless outweighed by the cost of weaker investment incentives and other dynamic losses which Professor Yarrow identifies.

71. Neither I nor Professor Yarrow can know the answer to this question with certainty, and I find that much of Professor Yarrow’s report seems to consist of a set of cautionary tales from different industries elsewhere in the world about the risk of intervening in the face of uncertainty. I think it would assist the ACCC more to point to the sort of evidence that would need to be assembled in order to weigh up the issues in this particular case. Paragraphs 55 to 85 of my original report did that.

72. I would make three additional points here. First, it should hardly need to be said that a regulatory intervention can result in a fall in quality accompanied by an even greater fall in prices such that we still see a positive impact on what Professor Yarrow terms ‘quality adjusted prices’. I gave an example of such a case above, where we saw that users may choose to pay more for higher quality products than they pay today, but as quality also rises those users will still be better off as a result. This means it is not necessary for the ACCC to show that declaration has a positive or no impact on investment in order for declaration to be in the LTIE. I make this point only because the Telstra submission contains the claim ‘Customers will face higher prices if roaming declared’, which suggests some confusion on Telstra’s part about Professor Yarrow’s use of the distinction between actual prices and quality adjusted prices.

likely to ensure that prices are already at competitive levels (b) I do not think the chain of substitution works well in this market, for the reasons explained earlier in this note.

40 Feasey report, para 80
41 I have no data, but it seems to me that there could be quite a large number of users in this category and it might be helpful for the ACCC to ask for Telstra’s assistance in trying to determine who they are.
42 Telstra submission, p.54
73. Second, a useful way to frame the question is to go back to what I identified earlier as being the critical question: ‘could existing levels of investment be sustained at lower prices than users pay today?’ If the answer is ‘no’ then there will be a difficult trade off to be made. This trade off might still be in the LTIE, but the sorts of cautions which Professor Yarrow provides in his 2nd Note would also carry significant weight with me. In my view, however, the answer is clearly ‘yes’ and so we can disregard many of Professor Yarrow’s concerns. I have shown above how the Ovum model submitted by Telstra appears to confirm that Telstra makes significant excessive returns from its captive users. These profits could be redistributed from Telstra to users, and Telstra would still earn sufficient returns to support an efficient level of network investment going forward.

74. If Telstra wants to argue that it requires non-competitive returns to fund further network investment, then I think it should say so clearly. Incidentally, I do not agree with Professor Yarrow (although I recognise he would not put it in these terms) that it is somehow better for a private firm like Telstra to be accorded a degree of leeway to exploit market power provided it applies the resulting rents to some cause which is deemed politically desirable. I do not think Telstra’s management have any mandate to assume such responsibilities upon themselves, and nor should they. Their job is to compete, and my understanding is that it is the job of the ACCC to ensure that they do. If there is then a need for elected politicians to allocate public subsidy to support network investments which the competitive market would not otherwise sustain, then I think that is the appropriate mechanism to use (irrespective of the potential pitfalls of such public subsidy schemes which Professor Yarrow identifies, and which I recognise).

75. Third, I think Professor Yarrow is unusual in being so clear in his own mind about the adverse dynamic effects of declaration whilst being so reticent and uncertain about the static effects. In my experience, most firms and most regulatory and competition authorities have precisely the opposite problem. Benefits in terms of short term price reductions are generally relatively easy to identify and quantify but the impact of any intervention on investment over the longer term is invariably more prone to speculation and a wide divergence of views. I find myself in the more conventional camp. I have used the Ovum model to explain earlier in this note why the static (price) benefits of declaration are both very substantial and easy to understand, even if their precise magnitude is always subject to some uncertainty and will depend on factors which I do not know at this stage, such as the wholesale pricing arrangements that are adopted by the ACCC.

76. I do not in any way discount the importance of network investment, but it is far from clear to me why declaration with an appropriate wholesale pricing regime need have any impact on Telstra’s

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43 2nd Note, esp. para 50
investment incentives provided that the effect of declaration and the wholesale pricing regime is that prices return to ‘competitive’ levels and do not fall below that. Telstra may nonetheless withhold investment in an attempt to ‘punish’ the regulator for intervening or to deter it from doing so in another context in future, or simply to follow through on a threat that was made prior to the intervention being made. I need hardly say that a regulator ought to disregard such threats.

77. In this case, Telstra have told us in their submission that $450-550 million of investment is contingent on the continuation of the current regime, although I note that Professor Yarrow does not refer to this figure, or any other, in his report or note. That figure might provide us with an upper bound in terms of the impact of declaration in respect of Telstra’s network. I recognise that we still need to consider the impact on VHA and Optus’ investment incentives, but their plans to invest in regional areas in the Maintained Position amount, according to Telstra itself, to little more than $100m. Thus, even if the incentives to compete on coverage were wholly eliminated by declaration— an extreme position which would not arise under any reasonable wholesale pricing arrangements – the absolute upper bound of any investment losses according to Telstra would be some $650m over a period of 3-5 years, and likely substantially less than that. That compares to price reductions to restore Telstra’s returns to ‘normal’ levels which I think could easily amount to several billion dollars over the same period. The precise effect of declaration on the evolution of retail prices would depend a great deal on the type of wholesale pricing arrangements which the ACCC chooses to adopt, a point I considered at length in my original report. Nonetheless, I think it is clear that the static benefits arising from declaration will exceed any dynamic costs imposed by Telstra by a margin which will far exceeds any threshold required by Professor Yarrow or by the ACCC itself.

78. I conclude, as Professor Yarrow does in his report, by asking ‘who benefits?’ Professor Yarrow answers the question correctly by noting that VHA and Optus will become more effective...

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44 This is not to say that I disregard Professor Yarrow’s comments about the importance of ‘regulatory reputation’, 1st Report, para 8.1 to 8.13. But the point can also be overplayed. Poorly reasoned, poorly implemented or unexpected interventions can deter future investment. But I am familiar with many examples of interventions by regulators which do not have this effect and it seems to me difficult to accuse the ACCC, after three enquiries over more than a decade, of acting in a mercurial fashion.

45 If, on the other hand, I thought VHA or Optus had any serious prospect of substantially replicating Telstra’s network, then the potential loss of investment would run into billions of dollars and Professor Yarrow’s warnings about dynamic losses would carry much more weight. I find no evidence that would allow the ACCC to assume that Optus or VHA would ever make such investments for the reasons explained elsewhere in this report.

46 The benefit calculus will depend to some extent upon the time period which the ACCC adopts in its assessment – what ‘long’ in LTIE is taken to mean. However, I think it easy to show that the value of price reductions that would obtained over even a 3 year period would far exceed the ‘costs’ of withheld network investments over the same period, and that the margin would likely increase beyond that point.

47 Feasey Report, para 135-151

48 1st Report, para 15.12
competitors for those urban users who value coverage highly. I agree. He then says competitive conditions will be ‘perturbed’. It is not quite clear what he means by this, but a plain English translation might be ‘competitive intensity increases’. I would expect both urban and rural users to benefit from such an increase in competition, and for that benefit to be reflected in the substantially lower (but still uniform) prices that millions of Australians will pay for their mobile services. I would expect those benefits, which are likely to amount to billions of dollars in price reductions over time, to far exceed the value of any quality benefits that might be forgone if Telstra follow through on their threat to withhold half a billion of network investment over the next 3-5 years. It is on this basis that I conclude that the LTIE will be advanced by declaration.

79. The alternative – Professor Yarrow’s ‘Maintained Position’ - is to ask those same Australian users to wait for VHA or Optus to invest the billions of dollars required to offer a viable competitive alternative to Telstra. Since there is no evidence of VHA and Optus ever being able to do so, for the reasons explained in my original report and in this note (and in other submissions made by VHA), that does not strike me as a very appealing prospect,

Richard Feasey
11 March 2017
2 March 2017

Email: fronfraithltd@gmail.com

Confidential and privileged

Mr Richard Feasey
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Dear Richard

Expert advice and opinion - ACCC Domestic Roaming Declaration inquiry

We act for Vodafone Hutchison Australia Pty Ltd (VHA) and are authorised to engage you to provide a further expert report (Report) in connection to the above matter.

To the extent possible, you must observe the Federal Court of Australia’s general practice note for expert evidence published in October 2016 in providing the Report (see Attached).

Background

On 5 September 2016, the Australian Competition and Consumer Commission (ACCC) commenced an inquiry into whether to declare a wholesale domestic mobile roaming service. As part of this inquiry, the ACCC released a discussion paper (Discussion Paper) for public consultation on 26 October 2016.

Telstra Corporation Limited (Telstra) made two submission to the Discussion Paper:

- dated 2 December 2016 (the Primary Submission); and
- dated 25 January 2017 (the Supplementary Submission).

Both the Primary and Supplementary Submissions are published on the ACCC website.

Instructions

Please provide a report addressing the expert reports submitted by Telstra in both its Primary and Supplementary Submissions, specifically the two reports by Professor George Yarrow.

Timing

We will require your Report to be finalised by 13 March 2017.

APAC-#40400545-v1

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You agree that:

• this letter and all communications (whether electronically maintained or not) between us, and between you and our client, are confidential. These communications may be subject to legal professional privilege. Accordingly, please ensure that you mark all documents in the following manner: Confidential – subject to legal professional privilege;

• you must take all steps necessary to preserve the confidentiality of our communications and of any material or documents created or obtained by you in the course of preparing your report;

• you must not disclose the information contained in our communications or obtained or prepared by you in the course of preparing your report without obtaining consent from us;

• you must obtain our consent before disclosing to any person that you have been engaged to provide an opinion in this matter;

• you must not provide any other person with documents which come into your possession during the course of preparing this report, whether created by you or provided to you by us or our client, without obtaining consent from us.

Your duty of confidentiality continues beyond the conclusion of your instructions.

If you are ever obliged by law to produce documents containing any of this confidential information (whether by subpoena or otherwise) please contact us immediately so that we may take steps to claim legal professional privilege on behalf of our client.

Any internal working documents and draft reports prepared by you may not be privileged from disclosure and may be required to be produced in any subsequent litigation.

We look forward to working with you.

Yours faithfully

Martyn Taylor
Partner
Norton Rose Fulbright Australia
4. ROLE AND DUTIES OF THE EXPERT WITNESS

4.1 The role of the expert witness is to provide relevant and impartial evidence in his or her area of expertise. An expert should never mislead the Court or become an advocate for the cause of the party that has retained the expert.

4.2 It should be emphasised that there is nothing inherently wrong with experts disagreeing or failing to reach the same conclusion. The Court will, with the assistance of the evidence of the experts, reach its own conclusion.

4.3 However, experts should willingly be prepared to change their opinion or make concessions when it is necessary or appropriate to do so, even if doing so would be contrary to any previously held or expressed view of that expert.

- Harmonised Expert Witness Code of Conduct

4.4 Every expert witness giving evidence in this Court must read the Harmonised Expert Witness Code of Conduct (attached in Annexure A) and agree to be bound by it.

4.5 The Code is not intended to address all aspects of an expert witness' duties, but is intended to facilitate the admission of opinion evidence, and to assist experts to understand in general terms what the Court expects of them. Additionally, it is expected that compliance with the Code will assist individual expert witnesses to avoid criticism (rightly or wrongly) that they lack objectivity or are partisan.

Annexure A - Harmonised Expert Witness Code of Conduct¹

APPLICATION OF CODE

1. This Code of Conduct applies to any expert witness engaged or appointed:

   (a) to provide an expert's report for use as evidence in proceedings or proposed proceedings; or

   (b) to give opinion evidence in proceedings or proposed proceedings.

GENERAL DUTIES TO THE COURT

2. An expert witness is not an advocate for a party and has a paramount duty, overriding any duty to the party to the proceedings or other person retaining the expert witness, to assist the Court impartially on matters relevant to the area of expertise of the witness.

CONTENT OF REPORT

3. Every report prepared by an expert witness for use in Court shall clearly state the opinion or opinions of the expert and shall state, specify or provide:

   (a) the name and address of the expert;

¹ Approved by the Council of Chief Justices’ Rules Harmonisation Committee
(b) an acknowledgment that the expert has read this code and agrees to be bound by it;

(c) the qualifications of the expert to prepare the report;

(d) the assumptions and material facts on which each opinion expressed in the report is based [a letter of instructions may be annexed];

(e) the reasons for and any literature or other materials utilised in support of such opinion;

(f) (if applicable) that a particular question, issue or matter falls outside the expert's field of expertise;

(g) any examinations, tests or other investigations on which the expert has relied, identifying the person who carried them out and that person's qualifications;

(h) the extent to which any opinion which the expert has expressed involves the acceptance of another person's opinion, the identification of that other person and the opinion expressed by that other person;

(i) a declaration that the expert has made all the inquiries which the expert believes are desirable and appropriate (save for any matters identified explicitly in the report), and that no matters of significance which the expert regards as relevant have, to the knowledge of the expert, been withheld from the Court;

(j) any qualifications on an opinion expressed in the report without which the report is or may be incomplete or inaccurate;

(k) whether any opinion expressed in the report is not a concluded opinion because of insufficient research or insufficient data or for any other reason; and

(l) where the report is lengthy or complex, a brief summary of the report at the beginning of the report.

SUPPLEMENTARY REPORT FOLLOWING CHANGE OF OPINION

4. Where an expert witness has provided to a party (or that party's legal representative) a report for use in Court, and the expert thereafter changes his or her opinion on a material matter, the expert shall forthwith provide to the party (or that party's legal representative) a supplementary report which shall state, specify or provide the information referred to in paragraphs (a), (d), (e), (g), (h), (i), (j), (k) and (l) of clause 3 of this code and, if applicable, paragraph (f) of that clause.

5. In any subsequent report (whether prepared in accordance with clause 4 or not) the expert may refer to material contained in the earlier report without repeating it.

DUTY TO COMPLY WITH THE COURT'S DIRECTIONS

6. If directed to do so by the Court, an expert witness shall:

(a) confer with any other expert witness;

(b) provide the Court with a joint-report specifying (as the case requires) matters agreed and matters not agreed and the reasons for the experts not agreeing; and

(c) abide in a timely way by any direction of the Court.
CONFERENCE OF EXPERTS

7. Each expert witness shall:

   (a) exercise his or her independent judgment in relation to every conference in which the expert participates pursuant to a direction of the Court and in relation to each report thereafter provided, and shall not act on any instruction or request to withhold or avoid agreement; and

   (b) endeavour to reach agreement with the other expert witness (or witnesses) on any issue in dispute between them, or failing agreement, endeavour to identify and clarify the basis of disagreement on the issues which are in dispute.