*THE ACCC'S DRAFT DETERMINATION IN RESPECT OF NBN CO'S APPLICATION FOR AUTHORIZATION OF ITS HFC SUBSCRIBER AGREEMENT WITH SINGTEL OPTUS AND OTHER OPTUS ENTITIES*

This paper comments on the ACCC's Draft Determination in respect of NBN Co's application for authorization of its HFC Subscriber Agreement with SingTel Optus and other Optus entities ("Optus"). It is presented in my own name and in a personal capacity.

In requesting the Commission reconsider its draft decision, I start by setting out some background and then consider the claimed benefits and the likely detriments, before turning to the weighting of those benefits and detriments.

## Background

It is useful to begin by summarizing the position the ACCC has taken until now to matters of this kind.

Central to that position is that whether one technology or market structure is more efficient than another should, wherever possible, be determined by the competitive process. Even if there are hypothetical gains from scale or scope economies that an acquisition or agreement between rivals might bring, it is preferable that those gains be achieved through competition between the firms at issue (leading, potentially, to the exit of one of those firms), rather than through an anti-competitive acquisition or agreement.

Moreover, to the extent to which the competitive process would ultimately lead to consolidation, those potential gains will be realized in any event. They are therefore not specific to the transaction, and hence do not in themselves distinguish the factual (the world with the transaction) from the counterfactual (the world without the transaction). The difference between the factual and the counterfactual would then mainly be one of timing (i.e. of when economies of scale or scope were realized), and any gains from those timing differences need to be weighed against costs from the loss of competition.

In assessing the scope for such gains, the ACCC has always been mindful of the fact that estimates of claimed cost savings are inherently uncertain. Additionally, where competitive tensions are reduced, potential efficiencies (such as those derived through economies of scale and scope) may be dissipated in excess costs. This is especially the case in government-owned entities, where there are inherently weak pressures to cost minimization and inherently powerful pressures for rent-sharing between management, unions and politicians at the expense of consumers.

Additionally, it cannot be assumed that regulation will provide an adequate, much less fully efficient, substitute for competition. Regulation is inevitably an imperfect process, beset by information asymmetries, high transactions costs and vulnerability to rent-seeking. Further, even where markets are regulated, competition, however limited, can help enhance the quality of regulation, including by forcing the disclosure of information through the give and take of competitive rivalry. As a result, the mere fact of regulation does not undermine the importance of protecting competition wherever that can reasonably be done—rather, the opposite is often true.

Last but not least, where competition is limited or restricted, it is especially important to protect what efficient competition there is. That competition, even if on a reduced scale, provides a benchmark that can help inform the market as a whole. Again, that benchmarking role is especially valuable where the dominant firm is government-owned, as it facilitates better monitoring and oversight of that firm and hence provides a wider benefit to the public and taxpayers generally. That wider benefit takes the form of increased discipline on the publicly-owned firm's costs, increased constraints on potential rent-seeking deals between the firm's management, unions and politicians, and an increased likelihood of taxpayers getting value for money (in the sense of the greatest benefit to the community at large) from the public's investment in the firm.

## The potential benefits

Those propositions are of direct relevance to the application at issue. In assessing that application, the ACCC finds that the principal public benefit lies in possible savings of costs of duplication and (to a lesser extent) of customer migration. The Commission says those benefits are "clear and quantifiable" while the competitive detriments are uncertain.

However, as an extensive literature shows, and as the Commission knows from its regulatory tasks, there can be substantial differences between cost estimates and actual outcomes. Those differences are likely to be especially large where the estimates involve a sophisticated, technically complex infrastructure that has not yet been installed in Australian conditions on a large scale, much less operated for sufficient time for costs to stabilize. The extreme difficulties NBN Co has had forecasting its costs and service deployment capacity, for instance in the context of new estates, highlights the extent of these uncertainties.

Under those circumstances, any cost estimates could be speculative and tinged with optimism bias. The uncertain character of those estimates will be all the more pronounced in this instance as what is at issue is the *difference* between costs – NBN Co's and Optus', in the factual and counterfactual respectively. Each of those firms operates infrastructure that is subject to rapid technological change in markets where demand itself is changing substantially, adding to the cost uncertainties. Moreover, those costs will likely be influenced by the outcome of the current process (for instance, the absence of competition encouraging less cost discipline at NBN Co). It is therefore difficult to see how the Commission can be confident in respect of likely costs.

Given those unavoidable uncertainties, one would have thought market processes would provide the best protection to consumers and the community. In particular, if the transaction is not authorized, it is likely, as the Commission notes, that the parties will compete. In that event, if NBN Co's quality-adjusted costs are genuinely lower than Optus', then it is likely to rapidly displace Optus;

if not, not. Moreover, at least in this instance, the greater the cost difference, the more rapid the process will probably be.

As a result, if the benefit is material, it will likely be realized in any event; conversely, if it is not material, displacement might prove a slow process or not eventuate at all, but even so, that would reflect the outcome of consumer valuations (suggesting the purported benefit was not actually a benefit). Of course, the rivalry between NBN Co and Optus may be distorted by NBN Co's artificially low cost of capital[1], which gives it an inherent advantage that likely more than offsets any distortion associated with its price averaging requirement; that artificially low cost of capital makes displacement likely to be quicker, rather than slower, meaning that any transactions-specific benefits are even slighter.

In short, the main benefit the Commission finds is far less certain, and less specific to the transaction, than the Draft Determination suggests.

## The detriment

The suppression of competition is undesirable in this instance for four reasons above and beyond those the Commission has considered. Each of these is associated with benefits that would be lost were the agreement authorized. As those losses were not considered by the Commission, the detriments of the agreement have been understated.

First, as NBN Co is a government-owned firm, it is not subject to the disciplines of competition in the market for corporate control. This increases the likelihood of its being operated inefficiently and of rent-seeking deals at consumers' expense. As the Commission's own comparisons of publicly- and privately-owned electricity networks businesses show, regulation is rarely sufficient to prevent those inefficiencies. However, competition can help make the regulation and control of entities such as NBN Co more effective, not merely through direct rivalry but also by providing a privately-owned benchmark for costs and customer service. To that extent, preserving competition results in a benefit to **all** consumers and taxpayers. Moreover, that benefit can be realized even if the competition is on a small scale, as was the case for many years between Optus and Telstra.

Second, the incentives facing Telstra, the likely largest single user of the NBN, will differ as between the factual and the counterfactual. Should Optus remain a fixed network competitor, that will give it some potentially significant advantages relative to Telstra, not merely in the fixed network but also in bundling and retailing fixed network and wireless services.[2] This is likely to

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[1] The Commonwealth has stated on numerous occasions that it believes the bond rate would be an adequate return for NBN Co.

[2] Those benefits include the avoidance of double marginalization. As the Commission notes, NBN Co's charges will be based on average costs. To the extent to which average and marginal costs differ, this creates a pricing distortion Optus will be able to avoid. At the same time, there may be other integration efficiencies, for instance, in terms of fault handling.

make Telstra compete more vigorously in those markets, which is itself a material benefit.

Third, as well as altering Telstra's incentives in downstream markets, the fact of Optus remaining a fixed network competitor will change Telstra's incentives in terms of its relations to NBN Co. In particular, it will strengthen Telstra's incentives (and those of other users of the NBN) to put pressure on NBN Co to manage its costs, as those costs will no longer affect all downstream competitors equally. Adding to the efficacy of those pressures, Optus will have greater bargaining power relative to NBN Co (as it will have its own network), improving its ability to discipline NBN Co's performance. Given the non-discrimination requirements, the resulting benefits will flow to all users.

Fourth, as the Commission itself notes, NBN Co is likely to respond to competition by aggressively promoting the very high speed services Optus' HFC is (in the Commission's view) unlikely to provide. This is all the more the case as the relevant customers are "high value" consumers NBN Co is keen to secure. Given its non-discrimination requirements, the effect will be to discipline NBN Co's prices and service quality, not merely in the HFC areas but more generally, for precisely those services which it seems uniquely placed to provide. Moreover, even if NBN Co sought to differentiate its service provision between those areas and others, access seekers and the public would be well placed to observe the difference, and hence place pressure on NBN Co to pass similar gains on more widely.

Each of these four benefits would be secured in the counterfactual and lost in the factual, and hence should be taken into account by the Commission in its assessment of the agreement.

## The balancing

The Commission must weigh the risks and costs of inappropriately granting authorization against the risks and costs of inappropriately denying it. The following considerations are relevant to that weighting.

First, as noted above, the assumed cost savings are speculative; in contrast, the benefits of competition are well-established, not least by the Commission itself. Moreover, the Commission must take account of the fact that in these proceedings, the interests of all the large and well-resourced participants, including the government, are in the agreement being authorized. As a result, there is a risk that errors in the case put by the applicants will be allowed to persist, while information and analysis that could tell against the application will not be presented. Finally, as data has not been publicly disclosed about the quantum of the claimed savings, the confidence that can be placed in those claims must be limited.

Second, if the Commission errs by inappropriately denying authorization, the costs will be largely self-correcting: NBN Co will likely rapidly displace Optus' HFC and achieve the claimed savings, albeit slightly later than it otherwise would. In contrast, if the Commission errs by inappropriately granting authorization, the costs will not be self-correcting; moreover, they will be difficult to reverse, if not irreversible.

Third, the Commission suggests that there are two factors that would limit the potential detriment: regulation and the price structure NBN Co has adopted. However, for reasons set out above, regulation is an imperfect tool, and those imperfections make it more, not less, important to preserve competition where one can. As for the price structure NBN Co has adopted, it is not apparent it would correct the error of improperly granting authorization even were NBN Co a privately-owned firm[3]; it is even less clear why it would do so in the case of a publicly owned firm, with all the distorted incentives public ownership brings.

Fourth, were the Commission to grant authorization, that would be a significant departure from its previous approach to matters of this kind.[4] While the Commission must decide each matter on its merits, it would seem unwise to make such a departure in a matter which, even on the Commission's own findings, is at best borderline.

Finally, it has been reported that the agreement at issue forms part of a condition precedent in Telstra's agreement with NBN Co. The question would then arise of whether rejecting this application would affect that agreement. That question must be considered by the Commission in terms of the incentives the parties to the Telstra-NBN Co agreement would face were such a rejection to occur. If the submissions of NBN Co and Optus in these proceedings are correct, rejecting authorization would have few implications for Telstra: as Optus would find it impossible to compete, any competitive effects would be slight and transient. As a result, it would remain in Telstra's interests and presumably those of NBN Co for their agreement to stand. It is only if those submissions are incorrect, and Optus would be an effective competitor, that material harm to Telstra could occur; but were that the case, that would merely confirm that authorization should not be granted, as it would cause the loss of otherwise durably effective competition.

As a result, the Commission should:

- For the reasons set out in the first factor above, place little evidentiary weight on the claimed benefits;

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[3] A profit-maximizing firm will increase output to the point where marginal cost equals marginal revenue. Acquiring a monopoly reduces the price elasticity of demand the firm faces and hence will lead to higher price levels and greater price-cost margins, regardless of the firm's price structure.

[4] For instance, the Commission has emphasized that for it to accept a "failing firm" argument for a potentially anti-competitive merger or agreement, "a firm must demonstrate that it is in imminent danger of exiting the market completely and is unlikely to be successfully restructured. ..There must also be no substantially less anti-competitive alternative to the merger – such alternatives may include purchase of the firm by a realistic alternative buyer or in some cases allowing the firm to fail may be less anti-competitive than the merger." Commissioner Sarah Court, "Cartels, consumers and the role of the regulator – proposed changes to the Trade Practices Act", 12 March 2009, Sydney.

- For the reasons set out in the second factor above, recognize that inappropriately granting authorization imposes a higher loss on consumers and the community than inappropriately denying it;
- For the reasons set out in the third factor above, place little weight on the factors that have been argued to mitigate the harm authorization would do to consumers;
- For reasons set out in the fourth factor above, exercise extreme caution in what would be a significant departure from the Commission's approach to such matters up to now; and
- For reasons set out in the fifth factor above, not accept arguments that rejecting this agreement could improperly threaten the agreement between NBN Co and Telstra.

Some comments on other benefits claimed by the applicants are in the attachment.

## Attachment: comments on claimed benefits

As well as cost savings from the elimination of duplication and from facilitating customer migration, the applicants claim benefits in terms of effects on NBN Co's deployment and deployment schedule; on its average costs; on its ability to recover costs; on energy efficiency and the environment; and on NBN Co's debt costs. While these are either not accepted by the Commission or given little weight, some comments on them are made below for the sake of completeness.

*Deployment*

NBN Co argues rejecting authorization would compromise its deployment or alter its deployment schedule. However, whether that causes a loss depends on whether consumers' valuations of the NBN exceed its costs, also taking third party effects into account. If competition from the HFC so reduces demand for NBN Co's services as to lead NBN Co to alter its deployment schedule, it is unlikely to be the case that such a cost-benefit test would be met. In any evidence, to consider this a loss from rejecting the application (and hence a benefit from accepting it), the Commission would need a rigorous cost-benefit test establishing the claim.

*Average costs*

Reduced usage of the NBN could increase NBN Co's average costs if costs are largely fixed and incremental (avoidable) costs are constant or decreasing.[5] In themselves, increases in average costs arising from spreading a given stock of fixed costs over a smaller volume of usage are not a detriment: if that stock of costs is unchanged, and the marginal users did not value the service at more than its avoidable cost, society is no worse off if those users leave the network, even if average costs rise as a result.

Increases in average costs could have real effects if they lead to increases in charges for access seekers on the NBN, affecting the competitive process between those access seekers and Optus.[6] However, NBN Co has stated that prices in its initial years are severely constrained by what the market will bear, making such increases unlikely, all the more so if NBN Co faces more intense competition. Moreover, assuming the parties' submissions are correct, the relevant demand would ultimately shift to NBN Co, reducing average costs, and in the meantime, there will have been consumer gains.

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[5] If incremental or avoidable costs are increasing in output, reduced utilization could reduce average costs.

[6] For instance, if Optus, by denying NBN Co its usage, could increase average costs so materially as to seriously increase Telstra's costs, it might have an incentive to do so, even if its own incremental costs were higher than NBN Co's. However, this 'raising rival's costs' effect requires Optus' volumes to be a relatively large share of total sales, as well as assumptions about how NBN Co and Telstra would react. Moreover, if Optus could do so, it seems unlikely it would want to enter into the agreement at issue.

That said, there are factors that could distort the outcome of the competitive process between NBN Co and Optus, so that efficient outcome might not prevail. However, on balance, those factors are more likely to result in the displacement of Optus by NBN Co, even if that is inefficient, than vice versa. In particular, though NBN Co is constrained by its uniform pricing requirement, it enjoys an extremely low cost of capital, and is strongly supported by guaranteed access to taxpayer-funded equity[7] and by taxpayer-funded services in kind (such as extensive government advertising on commercial TV). Indeed, the chairman of NBN Co has stated that the government has not set a rate of return target for the entity, which gives it ample ability to price aggressively.

As a result, changes in average costs are unlikely to involve a public detriment in this instance.

*Cost recovery*

Competition with Optus could defer or compromise NBN Co's cost recovery. However, it is not clear why any losses to NBN Co would not be more than offset by gains for consumers (and possibly, producer surplus for Optus).

In any event, NBN Co's cost recovery is heavily geared to the distant future. If NBN Co's submissions are correct, it will reasonably quickly displace Optus and hence return to its projected cost recovery time path. If despite the competitive advantages it has, it cannot do so, that suggests society is better off under the counterfactual than it would be were competition eliminated.

*Energy and environmental benefits*

These seem de minimis and in any event, largely including in the cost comparisons. Moreover, such benefits should be pursued on an economy-wide basis using environmental policy instruments, rather than through anti-competitive agreements.

*NBN Co's debt costs*

As a general matter, a reduction in debt costs per se is not a benefit; the possible benefit is the social value of the reduction in risk which is then reflected in those costs. However, whether that is a benefit depends on how it is obtained. In the case of securing such a reduction in risk through an anticompetitive agreement, the likelihood must be that the reduction in debt costs is simply the result of the increase in producer surplus. To the extent to which the weakening of competitive disciplines reduces incentives for cost control, and that is particularly likely in the case of government-owned businesses, the social gain

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[7] Under an agreement between the Commonwealth and NBN Co of 22 June 2011, the Commonwealth has committed to providing NBN Co with the equity required by its 2010 Corporate Plan through to 2021. Reflecting that commitment, NBN Co's Financial Statements, approved by its directors, its auditors and the Minister for Finance, record an obligation on the Commonwealth to supply NBN Co with $26.138 billion.

from that increased surplus will ultimately be dissipated in the form of excess costs.

Turning to the specifics at issue here, NBN Co is owned by the Commonwealth. The probability of the Commonwealth allowing an entity it owns to go into default on its fixed interest obligations must be extremely low. As a result, the effect of the outcomes of this application on NBN Co's risk premium is unlikely to be material.