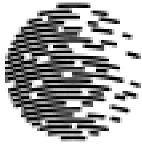

CABLE & WIRELESS
OPTUS

Optus submission responding

to the Productivity Commission’s Draft Report

Telecommunications Competition Regulation

—

June 2001

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Introduction – overview

Optus provides this additional paper to the Productivity Commission (the Commission), to provide a more in-depth response to a number of recommendations made by the Commission in its draft report, Telecommunications Competition Regulation.

This submission will make the following points:

Part XIB

- Part XIB provides a more effective mechanism than Part IV for addressing certain anti-competitive conduct in the telecommunications industry. There are two main reasons for this:

  (a) Part XIB is more expeditious than section 46

  (b) Part XIB incorporates an effects based test as opposed to a purpose-based test.

- Recent court judgements in the Melway and Boral cases do not mean section 46 can replace part XIB as suggested by the Commission. Also contrary to statements made by the ACCC, the Melway decision does not, "enhance and extend the law as set down in the Court's Queensland Wire Industries decision" nor does it set a new test, in any sense, for "taking advantage of".

- While, in the Boral case, the Full Court of the Federal Court has attempted to formulate a new definition of predatory pricing there remains considerable uncertainty about the application of this definition. Furthermore, the Boral case provides no new jurisprudence relevant to the general application of section 46. It is relatively confined to its facts, with little or no reasoning related to the "take advantage of" hurdle.

- Given that the technology behind telecommunications products changes rapidly, the first mover advantage in the development of products is important. Accordingly, the delays that are inherent in a section 46 action cannot provide participants in the telecommunications industry with the necessary rapid response. By contrast, competition notices have a more timely impact on the behaviour of the party engaging in anti-competitive conduct and are therefore a more appropriate regulatory instrument for the rapidly changing telecommunications industry.

- While the Commission is correct in stating that other jurisdictions do not have an equivalent to Part XIB, those jurisdictions have other mechanisms which assist in preventing anti competitive conduct or enabling a regulator and competitors to obtain evidence of anti competitive behaviour. These requirements include either structural separation in the case of the United States or stringent accounting separation requirements that provide transparency of an incumbent's costs.

- The effects test contained within Part XIB is integral to effectively protecting and fostering competition in Australia's telecommunications sector. This view is

supported by the tests that apply in other jurisdictions to determine whether a corporation has misused or abused its position of power within the market.

- A section 46 case, regarding Telstra's conduct in relation to many telecommunications services, would be difficult to make, given that it applies a purpose based test. For example Optus does not believe that section 46 would work anywhere nearly as effectively as Part XIB in the following cases:

    1. ***Flexstream:*** A section 46 case, regarding Telstra's pricing of its Flexstream product, would be difficult to make, given that under a purpose based test, the burden of proof rests on the claimant to present evidence proving an anti-competitive intent. This would be difficult to make given the nature of Telstra's conduct and the level of information asymmetry that characterises the telecommunications industry. Also Telstra would stand to benefit from protracted, drawn-out proceedings regarding its conduct in relation to Flexstream, as this would allow Telstra to gain a first mover advantage in the retail market for high speed internet access. Hence as a Part XIB action would prove to be more time effective than a section 46 action it is a more appropriate instrument to employ.

    2. ***Data interconnect:*** Telstra's current conduct regarding its data interconnect arrangements between Telstra and Optus is a failure to "do a positive act". Where there is a failure to do a positive act it is unlikely that a court will infer purpose. Hence section 46 of the TPA is inadequate to remedy this type of behaviour, however, by contrast, under an effects based test the regulator can act on developments such as these which will limit Telstra's ability to take advantage of its substantial market power in the market for fixed telephony services.

    3. ***Number portability:*** Telstra's market behaviour in relation to number portability is also a "failure to do a positive act". Accordingly section 46 is ineffective in dealing with the anti-competitive effects associated with Telstra' pre-porting processes.

Part XIC

- Optus agrees with the Commission's findings that the current declaration criteria are vague and may provide the ACCC with excessive discretion in the declaration of telecommunications services.

- By contrast an appropriate declaration test for originating and terminating electronic communications services of a service provider is one of substantial market power. This is so for the following reasons:

1. It is consistent with international telecommunications law,
2. Most OECD countries have telecommunications specific access regimes that, in terms of outcomes, regulate according to a substantial market power test,
3. A substantial market power test would more correctly capture areas of market failure,
4. The ACCC has previously suggested use of a substantial market power test,
5. The test is consistent with other sections of the Trade Practices Act.

- The Commission's proposed tests (b), (c), (d) and the "significance to the national economy" test in criteria (a) may be overly difficult to make in current areas of significant market failure and should therefore not apply to originating and terminating electronic communication services.

- In response to the Commission's proposed legislative pricing principles, Optus recommends that:

1. Principle 4 should take precedence over principle 1, where there are distorting retail price controls that hold the price of retail services below cost;
2. Principle 1 should be rewritten to provide for cost recovery over the full set of services supplied using the access input, not just regulated services; and
3. Pricing principle 2 is vague and should be removed.

Government erected barriers to entry

- The following government erected barriers to entry are key inhibitors of investment in core telecommunications infrastructure**:**

1. Retail price controls;
2. Barriers to new entrant build-outs such as proposed discriminatory local council charges on new entrant networks; and
3. Building access charges levied in a discriminatory manner by building owners on new entrant networks;
4. Unnecessary regulatory requirements such as the imposition of the Customer Service Guarantee (CSG) on new entrant networks.

- Local Councils should be prohibited from charging telecommunications providers for local distribution networks. If any charges are to be levied on utility distribution networks, they should be levied at the Federal level by the Commonwealth Government and all utilities should be charged at the same rate. This principle creates competitive neutrality between telecommunication infrastructure providers and between telecommunications networks and other utilities such as electricity, gas, and water

- The Commonwealth Government should review the carrier building access arrangements in the Telecommunications Act 1997 to ensure carrier building access rights are upheld. In particular, building owners should be prohibited from charging

new entrant networks for building access. Furthermore, any charges that are levied on telecommunications carriers by building owners must be levied in a competitively neutral manner.

- The CSG discriminatorily limits the capacity of telecommunications providers, other than Telstra, to compete via rolling-out local networks and through product differentiation. Hence the CSG should not apply to new entrant networks. Furthermore the government should consider the complete and progressive removal of the CSG in areas subject to fixed network competition, such as residential Melbourne, Sydney and Brisbane.

Pay TV

- Foxtel's current behaviour in relation to exclusive programming is not consistent with standard monopoly/profit maximisation models. Under the standard monopoly model, the monopolist does not exclude consumers who are prepared to pay the monopoly price. However, currently, Foxtel is restricting the supply of content to Optus independent of the price we are prepared to pay for that content. Foxtel is thereby restricting the class of subscribers available to view the content, independent of "willingness to pay considerations". This conduct has the affect of lowering profits and output levels to below profit maximising levels for a monopolist.

- FoxSports, in commercial discussions with Optus concerning the carriage of the FoxSports channels 1 and 2, have stated that their exclusivity arrangements with Foxtel prevent them from making an offer for the carriage of the FoxSports channels to Optus on any terms. Therefore, FoxSports have refused to progress the discussions beyond this point. This is contrary to FoxSports submission to the Productivity Commission which suggests that the reason Optus is unable to carry FoxSports is due to a failure by Optus to agree commercial terms with FoxSports.

USO

- The USO is currently funded by the entire telecommunications industry, independent of whether or not they make a profit. This arrangement is contrary to the basic tenet of taxation, which suggests that a tax should be levied on an ability to pay basis.

- If the Government is not minded to require Telstra to meet the costs of the USO, the next best alternative is to fund the USO through consolidated revenue. There are two advantages of such an approach:

    1. If the benefits of universal service subsidies were tied to transparent and real costs, then the level of universal service is likely to be more rational;

2. Telecommunications companies represent an economically inefficient and narrow funding base to achieve broad equity goals. General taxation is the appropriate funding mechanism to fund the pursuit of equity goals.

- An effective way to counter Telstra's incentive to overstate the true cost of the USO would be to levy the entire cost of the USO on the incumbent. Such an arrangement has been adopted in several overseas jurisdictions and has the following advantages:
  1. It would provide the correct incentives for the incumbent to minimise the cost of providing universal service,
  2. It would take into account the intangible benefits from being the universal service provider (USP).

Specific questions from the PC

- The Productivity Commission has sent a number of individual questions to Optus regarding number portability and pre-selection. Our broad response to these questions is that the Commission should make the following recommendations:

  1. The ACCC should be given the responsibility for determining whether or not each carriage service provider's (CSP) number portability solution is capable of providing equivalent service;
  2. The ACCC should be given powers to write porting process codes requiring carriers to install efficient porting processes;
  3. Donor CSPs should be prohibited from charging recipient CSPs for porting.
  4. CSPs should not be required to implement multi-basket preselection; and
  5. Preselection requirements should be modified so that they apply only where a carrier or CSP has substantial market power in a fixed network.

Structure of submission

The structure of this submission is as follows.

Chapter 1 discusses the ongoing need for Part XIB in light of the inadequacies of section 46 of the Trade Practices Act (TPA). It also presents three case studies highlighting the ongoing importance of Part XIB given the inadequacies of section 46 in dealing with anti-competitive conduct in the telecommunications industry.

Chapter 2 provides the Commission with follow-up information on the following issues:

(a) Optus' views concerning the Productivity Commission's proposed declaration test for telecommunications services; and

(b) Feedback concerning the wording of the Commission's proposed legislative pricing principles.

Chapter 3 discusses the adverse impact that a number of government erected barriers to entry have on investment in core telecommunications infrastructure. This chapter also suggests recommendations that the Commission should make to affect the removal of these government erected barriers to entry.

Chapter 4 addresses a number of issues, which arose from the Commission's hearings, regarding pay TV, content, and exclusivity.

Chapter 5 discusses the universal service obligation (USO) from a broad policy view and identifies a number of problems with the current application of the USO. It also identifies a number of future problems that may arise with the application of tendering.

Chapter 6 responds to a number of specific questions raised by the Commission regarding pre-selection and number portability.

1. Part XIB

Overview of the Chapter

1.1 This chapter will discuss the ongoing need for Part XIB in dealing with anti-competitive behaviour in the telecommunications industry. Specifically it will discuss:

a) The inadequacy of section 46 and the impact of recent cases on its potential effectiveness as a pro-competitive tool in dealing with anti-competitive behaviour in the telecommunications industry.

b) The need for the retention of Part XIB given Telstra's vertically integrated structure and the absence of rigorous accounting separation

c) The distinction between an effects based test and a purpose based test.

d) The ongoing importance of Part XIB in light of Optus' recent experience with Telstra's Flexsteam product and with Telstra's conduct regarding data interconnection arrangements and pre-porting processes. These are examples where part XIB, and or its threat, may be used in the future to bring about more economically efficient and competitive outcomes.

Key Points

1.2 This chapter makes the following key arguments:

— Part XIB can provide a more effective mechanism than Part IV for addressing certain anti-competitive conduct in the telecommunications industry. There are two main reasons for this:

(a) Part XIB is more expeditious than section 46

(b) Part XIB incorporates an effects based test as opposed to a purpose-based test.

— The Melway decision does not "enhance and extend the law as set down in the Court's Queensland Wire Industries decision" nor does it set a new test in any sense for "taking advantage of".

— In the Boral case, the Full Court of the Federal Court has attempted to formulate a new definition of predatory pricing, however there remains considerable uncertainty about the application of that definition. Furthermore, the Boral case provides no new jurisprudence relevant to the general application of section 46. It is relatively confined to its facts, with little or no reasoning related to the "take advantage of" hurdle.

- Given that the technology employed by telecommunications products changes rapidly, the first mover advantage in the development of products is important. Accordingly, the delays that are inherent in a section 46 action cannot provide participants in the telecommunications industry with the rapid response necessary in dealing with anti-competitive conduct. By contrast, competition notices have a more timely impact on the behaviour of the party engaging in anti-competitive conduct and are therefore a more appropriate instrument for the rapidly changing nature of the telecommunications industry.

- While the Commission is correct in stating that other jurisdictions do not have an equivalent to Part XIB, those jurisdictions have other mechanisms which assist in preventing anti competitive conduct or enable a regulator and competitors to obtain evidence of anti competitive behaviour. These requirements include either structural separation as in the case of the United States or stringent accounting separation requirements that provide transparency of an incumbent's costs.

- The effects based test contained within Part XIB is integral to effectively protecting and fostering competition in the telecommunications sector in Australia. This view is supported by the tests that apply in other jurisdictions to determine whether a corporation has misused or abused its position of power within the market.

- Three case studies are presented to illustrate the ongoing importance of Part XIB:

    (a) Flexstream;

    (b) Data Interconnection; and

    (c) Telstra's pre-porting processes.

(a) **Flexstream**

- Telstra is engaging in a price squeeze in relation to the supply of both Flexstream, and its retail ADSL product because the difference in price between the two products does not enable an efficient downstream competitor to offer a competing service to Telstra's BigPond service.

- Telstra's pricing of its Flexstream product also constitutes a constructive refusal to supply. The Flexstream service is an essential input into the supply of retail high-speed internet access to residential customers given that at current prices for ULLS it is unprofitable for Optus to acquire each of the individual component elements of Flexstream at a price which would allow it to provide a competitive retail ADSL service, to the residential market.

- Telstra's pricing structure for its Flexstream product has the effect of substantially lessening competition in the market for products dependant on high-speed bandwidth to residential customers, small office, home office

workers (SOHOs) and small businesses. Telstra's failure to offer a viable wholesale product to downstream service providers has meant that many ISP's such as Excite@Home have been unable to offer an ADSL product. As a result, Telstra is currently the sole player in Australia offering ADSL services to end users on a geographically widespread basis.

— A section 46 case, regarding Telstra's conduct in relation to its Flexstream product, would be difficult to make, given that it applies a purpose based test. However an effects based test as applied by part XIB would be a more appropriate test given the nature of the conduct and the level of information asymmetry that exists.

(b) **Data Interconnection**

— Current arrangements regarding data interconnection are sub-optimal as they are costly and result in call service degradation. These arrangements are costly because they rely on trunk switches, on both sides of the point of interconnect (POI), which are designed for voice traffic, and therefore inefficiently handle long held data calls. Furthermore, given the limitations of the trunk switches, interconnection at times of peak capacity may not be achieved for all data calls leading to service quality degradation.

— Telstra has to date failed to offer a data interconnect solution which will allow Optus to achieve the same cost efficiencies and network utilisation that Telstra itself achieves from its own internal service. Going forward this will limit the ability of Optus to grow its ISP business.

— Telstra's refusal to offer Optus the network access switch (NAS) optimum solution for data interconnect and to upgrade the capacity of its PSTN network is a failure to "do a positive act". Where there is a failure to "do a positive act" it is unlikely that a court will infer purpose. Hence section 46 of the TPA is inadequate to remedy this type of behaviour. By contrast, under an effects based test the regulator can act on developments such as these which will limit Telstra's ability to take advantage of its substantial market power in the market for local access services

(c) **Telstra's pre-porting processes**

— In a competitive telecommunications environment, most business customers demand short and certain timeframes for porting. However Telstra's current pre-porting processes cause porting delays, and make it impossible for recipient carriers to provide definite porting timeframes to business customers wishing to port away from Telstra. This, in effect, is a barrier to entry as it inhibits the ability of Optus to compete in the business market.

— To date Telstra has refused to proactively address the problems inherent in its pre-porting processes by upgrading its network capacity. Telstra has also refused to agree to maximum timeframes for completing the pre-port studies (PPS) or for undertaking network capacity upgrades.

— Telstra's refusal to proactively upgrade its network capacity and to agree to maximum timeframes for completing PPS and network capacity upgrades is in effect a "failure to do a positive act". Accordingly section 46 is ineffective in dealing with the anti-competitive effects associated with Telstra' pre-porting processes.

What has the Commission recommended?

1.3 In its draft report *Telecommunications Competition Regulation* the Commission has recommended that the anti-competitive conduct provisions of Part XIB of the Trade Practices Act 1974 (TPA)[1] be repealed or alternatively, that they be amended to modify its undesirable features.[2]

1.4 The Commission's rationale for this recommendation includes the following:

(a) There is a high risk of error in applying any regulation—in particular behavioural regulation as embodied in Part XIB.

(b) The efficiency gains from the use of Part XIB have been relatively low as it has lead to increases in distributional rather than productive efficiency.

(c) The competition notice regime risks discouraging pro-competitive behaviour and undermining incentives to invest.

(d) There have been very few anti-competitive conduct cases under Part XIB, with none since the 1999 amendments came into effect. This calls into question its utility in stopping anti-competitive conduct;

(e) There are alternative remedies to Part XIB such as section 46. The Commission concludes that there is little real difference' between the effects based test under Part XIB and the purpose based test under section 46;

(f) Progress in actions under Part XIC to date, together with further improvements in the access provisions reduce the need for the anti-competitive conduct rules contained in Part XIB; and

(g) Australia is alone in the world in incorporating an effects based test, including likely effect, into its approach to anti-competitive conduct.

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[1] Part XIB of the TPA establishes an anti-competitive conduct regime for telecommunications markets additional to that applying generally to all markets under Part VI. There are two central differences between Part XIB and Part VI: Part XIB makes use of an effects test, whereas Part IV uses a purpose test; Part XIB, but not Part IV, allows the ACCC to issue competition notices to firms it alleges are engaged in anti-competitive conduct. Such notices effectively reverse the onus of proof.

2 Productivity Commission, Telecommunications Competition Regulation: draft report", p.XXXIII.

Optus' views on the Commissions approach

1.5 As detailed in our preliminary response, Optus disagrees with the Commission's recommendation regarding Part XIB. Telstra's ubiquitous network and integrated nature continue to provide Telstra with extensive market power in fixed telephony services as well as a range of new technology services. Hence, there remains a need for strong conduct rules, supplementing the general provisions of the TPA, so that expeditious and effective responses to anti-competitive conduct can be achieved.

There is an ongoing need for the retention of Part XIB

1.6 Part XIB is a more effective mechanism than Part IV for addressing certain anti-competitive conduct in the telecommunications industry. There are two main reasons for this:

a) ***Part XIB is more expeditious than section 46.*** Expeditious remedies to anti-competitive behaviour are essential for the promotion of competition given that delay often favours the incumbent. As the ACCC stated in its submission to the Productivity Commission's review of Telecommunications Specific Regulation:

> *"The ACCC's recent experience is that the time between instituting proceedings and obtaining final court orders is a minimum of 12 to 18 months and up to 6 years. This delay invariably benefits the incumbent."*[3]

By contrast, under Part XIB resolution of complaints has taken between 9 to 27 months.

Furthermore, under Part XIB the regulator is able to continue to "build its case" between issuing a Part A notice (which has no evidentiary effect) and issuing a Part B notice (which constitutes prima facie evidence of a contravention) which it cannot do in ordinary Part IV proceedings. This provides the ACCC with a degree of flexibility and enables the ACCC to 'calibrate' its regulatory response in a way which it could not do under Part IV.

b) ***Part XIB incorporates an effects based test as opposed to a purpose based test.*** An effects based test requires a court to look at the relevant market and determine whether there has been a substantial lessening of competition. An effects based test is essential in the telecommunications industry given Telstra's incumbency and entrenched market power. As stated by Power-Tel:

> *"In an industy with an entrenched player such as Telstra, where the aim is to foster competition, if the effect of conduct is anti-competitive, even if the purpose was not, it is a matter of concern from both a competition perspective and from a public policy perspective*."[4]

[3] ACCC, Submission to the Productivity Commission

[4] PowerTel, Submission to the Productivity Commission, 17 September 2000 p.16

Also information asymmetry and the non-transparent nature of cost and internal transfer prices means that establishing a case under section 46 is made extremely difficult, as it requires proof of a proscribed anti-competitive purpose. By contrast an effects based test focuses on the social welfare implications of the conduct and how the conduct effects the efficient operation of the competitive process. Hence an effects based test is a more appropriate test to apply given the level of information asymmetry that exists.

Impact of recent cases

1.7 The Productivity Commission in its public hearings has suggested that recent case law relating to section 46 illustrates the increasing effectiveness of section 46 in dealing with competition issues. The Commission has referred to statements by the ACCC which indicate the potential for section 46 to be more effectively used following the recent judgements in the cases of Boral and Melways. The Commission appears to consider that this recent case law has broadened the scope of application of section 46 and that this is likely to reduce the requirement for telecommunications specific provisions.

1.8 Optus notes the ACCC's statements in relation to both Boral and Melways.

1.9 Following the Boral case the ACCC released a statement which said that:

> "*The Court has endorsed the ACCC's approach and recognised that below cost pricing can be a misuse of market power, even in markets where there is more than one large player….The judgement has important implications for the ACCC's trade practices enforcement program. .. It assists new entry into markets and protects efficient small businesses from abuses of well-financed larger players. This ruling will enhance the ability of small businesses to enter and compete in markets with big businesses. The Full Court of the Federal Court's clarification of section 46 provides another means of protecting the legitimate interests of small businesses.*"

1.10 In relation to the Melways decision the ACCC said:

> *"the decision clarifies the meaning of critical aspects of the misuse of market power provisions, in particular what it means for a firm with a substantial degree of power in a market to 'take advantage' of that power for an anti competitive purpose…. The ACCC submitted that conduct may 'take advantage' of a substantial degree of market power within the meaning of section 46 where the conduct is facilitated or made easier by that market power. The ACCC submission on this issue was accepted in principle by the Court and, in doing so, the Court enhanced and extended the law as set down in the Court's Queensland Wire Industries decision."*

1.11 Optus believes the eagerness expressed by the ACCC in its press releases probably overstates the likely impact of the decisions on competition issues in Australia.

The Melway case

1.12 Optus' view is that the Melway decision does not "enhance and extend the law as set down in the Court's Queensland Wire Industries decision" as suggested by the ACCC in its press release.

1.13 Rather the court in its majority judgement states the following:

> *"Dawson J's conclusion that BHP's refusal to supply QWI with Y-bar was made possible only by the absence of competitive conditions does not exclude the possibility that, in a given case, it may be proper to conclude that a firm is taking advantage of market power where it does something that is materially facilitated by the power even though it may not have been absolutely impossible without the power. To that extent, one may accept the submission made on behalf of the ACCC, intervening in the present case, that s 46 would be contravened if the market power which a corporation had made it easier for the corporation to act for the proscribed purpose than otherwise would be the case."*

1.14 In Melways the High Court has clarified that the Queensland Wire decision does not rule out the possibility that in an appropriate case, it could be found that there was a taking advantage of the power where something was materially facilitated by the power even though it would not have been absolutely impossible without the power. However the decision does not set a new test in any sense for taking advantage and Optus does not believe that it extends or enhances the test.

1.15 Unfortunately, the decision in Melways cannot be read as an endorsement of the ACCC's submission that "*there will be a taking advantage of market power where the conduct is facilitated or made easier by that market power*." It is clear from the reference to "*To the extent that*" in the above paragraph that the High Court continues to endorse a relatively narrow application of the "take advantage of" test. While Optus supports the ACCC's submission, Optus does not believe that the Melways case endorses the ACCC's position.

The Boral case

1.16 Optus recognises that the Full Court of the Federal Court in Boral has dismissed the idea that there must be an expectation of recoupment before there can be a finding of predatory pricing and that below cost pricing is not necessary to establish predatory prices. However, the decision does not provide a single principle in respect of predatory pricing. When one examines the judgements it appears that while the judges may be clear on what they believe is not necessary to show predatory pricing (ie an expectation of recoupment) they are less clear on what must be demonstrated in order to show predatory pricing.

1.17 Finklestein J said:

> *" In my opinion the existence of predatory pricing should not be determined by reference to some precise formula or definition. Predatory pricing is no more*

than a price set at a level designed to eliminate a competitor or keep a potential competitor from the market. That is the gist of the definition given by Professor Hay that I mentioned earlier in these reasons. It is all that is necessary for the purposes of section 46. In particular, in my view, it does not matter that the price charged might exceed either the average total cost or average variable cost. In the circumstances of the case it may nevertheless be a predatory price. I do not agree with the view that there is a cost (eg average variable cost) below which there must be a per se finding of predatory pricing. I would accept, however that for the purposes of a prosecution under section 46, if a dominant firm persistently prices its goods below average total cost, predatory intent may be inferred and the inference would be much stronger if the price was set below average variable cost. At least in the latter case it would be for the firm to show that there was a legitimate purpose for its conduct."

1.18 Optus would argue that while the Federal Court has attempted to formulate a new definition of predatory pricing there remains considerable uncertainty about the application of that definition. Finkelstein J's definition of predatory pricing as being pricing set at a level designed to eliminate a competitor or keep a potential competitor from the market provides little guidance as to how a court might distinguish between predatory pricing and competitive pricing.

1.19 Similarly, Optus would argue that the Federal Court's reference to the fact that only a monopolist or a person with monopoly power can recoup profits is inaccurate. If a firm possesses market power it can have a degree of confidence about the level or likelihood of future profit or recoupment without necessarily requiring monopoly power.

1.20 Further, the Boral case provides no new jurisprudence relevant to the general application of section 46. It is relatively confined to its facts, with little or no reasoning related to the "take advantage of" hurdle.

Application of Melway and Boral to telecommunications

1.21 Optus also believes that when one examines the path of the Boral and Melways cases through the courts it adds support to its argument that section 46 is not the appropriate mechanism for dealing with a dynamic industry such as telecommunications.

1.22 The conduct that was in issue in Melways took place in 1996 with the judgement of the single judge being handed down in 1998. Similarly the conduct in Boral took place between 1993-1996 and the judgement at first instance was handed down in 1999. In both cases therefore there was a delay of over two years before there was an initial decision and in both cases the initial judgment has been appealed all the way to the High Court, with Boral applying for special leave to the High Court.

1.23 In both Melways and Boral the products under consideration were static in the sense that they did not involve rapidly changing technologies and the markets in

which those products were being sold were relatively stable. In contrast the technology behind telecommunications products changes rapidly and first mover advantage in the development of products is important. Accordingly the delays that are inherent in a section 46 action cannot provide participants in the telecommunications industry with the rapid response that is needed.

1.24 While acknowledging that competition notices like a section 46 case are subject to review, Optus again notes the length of time that its current section 46 proceedings have taken. It is impossible for section 46 to respond in a manner that is appropriate to the rapidly changing nature of the telecommunications industry.

Vertical integration and structural separation

Structural Separation or Accounting Separation

1.25 In its public hearings, the Commission also queried Optus statements that Parliament introduced telecommunication specific regulation in Part XIB because of the absence of structural separation in Australia. After further review, Optus believes there is clear evidence for Parliament's intention in this regard.

1.26 The impact of a vertically or horizontally integrated monopoly was specifically recognised by the Government at the time the legislation was introduced. In the Explanatory Memorandum to Part XIB it states:

> *"Telecommunications is extremely complex, horizontally and vertically integrated industry and competition is not fully established in some telecommunications markets. There is considerable scope for incumbents to engage in anti-competitive conduct because competitors in downstream markets, depend on access to networks or facilities controlled by the incumbents. Furthermore, the possibility of anti-competitive cross subsidies by incumbents from non-competitive markets to markets in which competition exists or is emerging is a particular threat to the establishment of a competitive environment. Total reliance on Part IV of the TPA to constrain such anti-competitive conduct might in some cases, prove ineffective because of the state of competition in the telecommunications industry and the fast pace of change in this industry. There may be difficulty, for example, in obtaining evidence of predatory behaviour supported by inappropriate internal cost allocation by horizontally or vertically integrated firms. Anti –competitive behaviour in telecommunications could cause particularly rapid damage to competition because of the volatile state of the industry during the early stages of competition. Against this background, Part IV alone may prove insufficient to deal with anti competitive behaviour in telecommunications at this time."*

1.27 References to vertical integration are clearly relevant to the introduction of Part XIB. Structural separation would address this issue. Accordingly, we believe

Parliament has evinced a clear intention that Part XIB is required due to Telstra's vertically integrated structure.

1.28 While the Commission is correct in stating that other jurisdictions do not have an equivalent to Part XIB, those jurisdictions have other mechanisms which assist in preventing anti competitive conduct or enable a regulator and competitors to obtain evidence of anti competitive behaviour. These requirements include either structural separation in the case of the United States or stringent accounting separation requirements which provide transparency of an incumbents costs.

Commission reliance on international comparisons.

1.29 In its draft report the Commission argues that other countries deal with anti competitive conduct through generally applicable competition rules. The Commission notes that Hong Kong appears to be an exception. The Commission then goes on to examine the competition regimes in place in New Zealand, Canada, the United Kingdom and Ireland, the United States and Hong Kong. The Commission states that of the countries mentioned, Australia alone explicitly incorporates an effects based test, including likely effect, devoid of purpose, into its approach to anti competitive conduct regulation of telecommunications markets. The Commission relies on this approach to support its recommendations for the abolition of Part XIB.

1.30 Optus would make two points about this reliance on international precedent to justify the argument that abolishing Part XIB would bring Australia into line with other international jurisdictions.

a) Firstly, the competition provisions that apply in respect of telecommunications cannot be looked at in a vacuum divorced from other arrangements that apply to the telecommunications industry. In at least five of the six countries examined by the Commission there is either vertical separation or stringent accounting separation requirements placed on of telecommunications operators. In addition many countries also have additional licence conditions that apply to operators with a substantial degree of market power or other provisions that can be regarded as having an impact on anti competitive behaviour that apply in addition to the general competition law

b) Secondly, many countries, which on the face of their legislation only take into account a purpose requirement, do take "effect" into account when applying the relevant legislation. Each of these points are addressed below.

United States**:** The United States is the key example of a jurisdiction where vertical separation has been mandated. In 1982 AT& T was required to divest itself of subsidiaries operating local phone services because of concerns about its ability to foreclose long distance competition through its control of local telephone networks. While the 1996 US Telecommunications Act now permits incumbent local exchange carriers to re enter the long distance market they may only do so once they have demonstrated to the FCC that they have met competitive safeguards designed to foster competition both in local and long distance markets. In addition even if an incumbent operator meets these

competitive safeguards it must operates its competing long distance business in a separate company, all dealings must be at arm's length and there must be no sharing of key management or sales personnel.

Canada: While the Canadian CRTC has generally rejected calls for structural separation between the long distance and local call elements of the incumbent telecommunications operators, it has adopted other safeguards in order to prevent discrimination and cross subsidisation from monopoly service customers.[5] In addition, the Minister for Communications has imposed structural separation for cellular telephone services. In a similar fashion the government has encouraged structurally separate subsidiaries in situations where telecommunications companies seek broadcasting licences in order to protect against anti competitive behaviour arising from cross subsidies where telecommunications services and broadcasting services are offered over the same facilities.

United Kingdom: OFTEL has required British Telecom (BT) to provide separate accounts for its network and retail arms and to make these accounts publicly available. In addition there must be arms length dealing between BT's wholesale and retail business and there must be prior notification of and agreement on technology and service changes by BT. Finally, competitor information at the wholesale level is quarantined from BT's retail business.

Ireland: While Ireland does not have structural separation the licensing regime provides that a general licensee who has significant market power must comply with additional conditions as part of its licence. These additional conditions include conditions relating to retail price control, cross subsidisation, separate accounts, and alteration to the licensee's network.

In 1999 the Office of the Director of Telecommunications Regulation issued a decision setting out the requirements for accounting separation and publication of financial information for telecommunications operators; D10/99. In that decision the Director stated that:

> *"the purpose of accounting separation is to provide an analysis of information derived from financial records to reflect as closely as possible the performance of parts of a business as if they were operating as separate businesses. This allows competing operators to have confidence that an SMP Operator is not unduly discriminating between itself and competing operators or between one competitor and another when providing similar services.*

European Union: The European Union requires incumbents to comply with the following:

- transparency , non discrimination and accounting separation;
- cost orientation of interconnection tariffs

5 See Review of Regulatory Framework Decision 94-19

Hong Kong: Accounting separation is also required in Hong Kong for the dominant operator who is required to maintain and report accounts for different service segments of the licensed operation. The relevant accounting practices are specified in an accounting manual issued by OFTA.

Effects v purpose

1.31 The Commission has argued in its draft report that the effects based test contained in Part XIB is no longer necessary and that a purpose based test is sufficient. It states that the difference between the two tests are not significant. However, Optus disputes the accuracy of the Commission's claim.

1.32 Optus would argue that it is clear from the case law that there is a distinction between purpose and effect. In Chan Cuong Su/ra Ausviet Travel v Direct Flights International Pty Ltd (No2) Lehane J stated**:**

"there is ….a clear distinction between purpose and effect. It is perfectly possible that conduct entered into for a legitimate purpose may nonetheless have the effect, for example of preventing the entry of a person into a market".

1.33 Optus is of the view that the effects based test contained in Part XIB is integral to effectively protecting and fostering competition in the telecommunications sector in Australia. This view is supported when one considers the tests that apply in other jurisdictions to determine whether a corporation has misused or abused its position of power within the market.

1.34 Optus also disagrees with the Commission's view that Australia is unique in using an effects based test.

Canada: In Canada, the competition provisions clearly refer to effect or likely effect. Sections 78 and 79 of Canada's Competition Act 1986 prohibit one or more persons from abusing their dominant market position. Also section 79(1) states*:*

"Where, on application by the Director, the Tribunal finds that:

- *one or more persons substantially or completely control, throughout Canada or any area thereof, a class or species of business,*

- *that person or those persons have engaged in or are engaging in a practice of anti-competitive acts, and*

- *the practice has had, is having or is likely to have the effect of preventing or lessening competition substantially in a market,*

the [Competition] Tribunal may make an order prohibiting all or any of those persons from engaging in that practice."

United States*:* Section 2 of the Sherman Act renders it unlawful for a person to monopolize, attempt to monopolize, or combine or conspire with any other

person or persons to monopolize a line of commerce. An action against a party for monopolisation has two elements: possession of monopoly power, and the wilful acquisition, maintenance or use of that power by anti-competitive or exclusionary means for anti-competitive or exclusionary purposes.[6]

When considering the second limb of this monopolisation offence, the courts focus primarily on the conduct of the defendant rather than on intent. The conduct must be deliberate, and anti-competitive and exclusionary. In doing so the courts are looking at effect rather than purpose. Case law has established a number of forms of conduct that have such an effect, including leveraging, pricing below cost, imposing illegal ties, excessive advertising and other conduct that raises a competitor's costs or risks of entering the market.

***Hong Kong**:* Under Section 7L(4) of the Telecommunications (Amendment) Ordinance 2000:

> *"a licensee is deemed to have abused its dominant position if, in the opinion of the Telecommunications Authority (TA) it has engaged in conduct that has **the purpose or effect** of preventing or substantially restricting competition in a telecommunications market." (emphasis added).*

***United Kingdom*:** The UK's Competition Act 1998 contains what can be viewed as an effect based test given the language that the provision is framed in. Section 18(1) of the Act provides:

> *"Subject to section 19, any conduct on the part of one or more undertakings which amounts to the abuse of a dominant in a market is prohibited if it may affect trade within the United Kingdom".*

In addition, BT's licence contains a fair trading condition which prohibits activities carried on when providing telecommunication services or running a telecommunications system that "*have, or are likely to have, the object or effect of preventing, restricting or distorting competition*". Therefore, the condition places a prohibition on conduct that amounts to an abuse of dominance or has an adverse effect on competition.

European Union: The domestic proscription of abuse of market power in many European countries is drawn from Article 86 of the Treaty of Rome. The Court of Justice of the European Communities (**ECJ**) defined "abuse" in the context of article 82 (formerly article 86) as:

> *"The concept of abuse is an objective concept relating to the behaviour of an undertaking in a dominant position which is such as to influence the structure of the market where, as a result of the very presence of the undertaking in*

[6] *Aspen Skiing Co v Aspen Highlands Skiing Corp.*, 472 US 585, 595-96 (1985).

question, the degree of competition is weakened and which through recourse to methods different from those which condition [normal commercial operations] has the effect of hindering the maintenance of the degree of competition still existing in the market or growth of that competition".[7]

In the Continental Can case[8], the European Court of Justice (ECJ) stated that:

"the question of causality between the offence of abuse of dominance and the actual exercise or use of that dominance was of no consequence, because the reinforcement of a position of dominance may still be an abuse as prohibited by Article 86 "regardless of the means and procedure by which it is achieved, if it has the effects [of substantially fettering competition]".[9]

1.35 This expansion of the operation of Article 86 means that the abuse of dominance test is broader than that in Part XIB because it does not require an equivalent of the "take advantage" threshold test in Australia.

1.36 Three case studies are now presented to illustrate why Part XIB will continue to be, a superior instrument for dealing with Telstra where it engages in anti-competitive conduct.

The Flexstream case study

1.37 Telstra Flexstream[10] allows an access seeker to simultaneously offer high-speed data services on the same copper loop that Telstra offers traditional voice telephony service[11]. Flexstream is an important input into the retail provision of ADSL and xDSL services such as high speed internet access and interactive digital television. ADSL[12] requires access to the high frequency portion of a copper local loop only – not the entirety of the frequency distribution on the loop. Consequently, it is suitable for use on copper local loops that are already being used to deliver voice services.

1.38 Telstra's conduct in relation to the supply of Flexstream can be characterised in two ways: as a price squeeze and as a constructive refusal to supply.

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7 *Hoffman-La Rouce & Co AG v Commission* [1979] 2 ECR 461.

8 Case 6/72 *Europemballage Corporation and Continental Can Company Inc. v EC Commission* [1973] ECR 215; 72/21 EEC *Re Continental Can Company Inc. and Europemballage Inc.* OJ [1972] L7/25.

9 *Continental Can* case, para 27.

10 Telstra Flexstream is a wholesale service supplied over a Qualified Pair where Telstra supplies operational standard telephone services over the same Qualified Pair .

11 The Flexstream product can be thought of as the high frequency portion of the copper loop that Telstra uses in delivering voice telephony services.

12 ADSL technology is eminently suitable for products, such as high speed internet access, where more data is downloaded (such as Web pages) than is transmitted (such as email) given that it offers bandwidths such as 6.0Mb/s downstream (to the customer) and 640kb/s upstream (from the customer).

Telstra is engaging in a price squeeze

1.39 A price squeeze occurs when a supplier agrees to supply at a particular price, or on other terms or conditions of supply, however the price and/or conditions are such that the purchaser cannot compete in the downstream market so the effect is similar to an outright refusal to supply.

1.40 Telstra is engaging in a price squeeze in relation to the supply of both Flexstream, and its retail ADSL product because the difference in price between the two products does not enable an efficient downstream competitor to offer a competing service.

1.41 Currently, Telstra officially prices its wholesale Flexstream product to competitors at approximately $95 per month (excluding GST) which translates to an effective cost of $104.50 per month (including GST). This compares to the retail price of Telstra's BigPond DSL product for residential preselected (Telstra preselected) customers at $78 per month (including GST). The wholesale product is more expensive than the retail downstream product. Hence, Telstra's current pricing structure means that even the most efficient access seeker is unable to compete in downstream DSL dependent markets.

1.42 In addition to the pricing issues discussed above, Telstra is engaging in the discriminatory supply of wholesale high-speed bandwidth services. Telstra wholesale supplies to Telstra Retail a 512Kb/s wholesale service, as evidenced by Telstra Bigpond's Freedom Deluxe service, but fails to supply an equivalent Flexstream product to access seekers. Telstra Flexstream offers access seekers the choice of only two bandwidth offerings: a 256Kb/s downstream service and 1.5Mb/s downstream service. Telstra refuses to supply, at the wholesale level, a 512Kb/s service despite this having been a key issue in negotiations between Optus and Telstra.

1.43 The experience of Excite@Home (in which Optus owns a 50% holding) suggests that a service of at least 500Kb/s is essential. Firstly, much of Excite@Home's broadband content, particularly video, is encoded at speeds of 350-400Kb/s. Hence, a service offering of 256Kb/s would not provide optimal performance for that content without reducing a customer's broadband "experience." Secondly, interactive games are a core and growing component of Excite@Home's content and this would be particularly affected by a service that was limited to 256Kb/s.

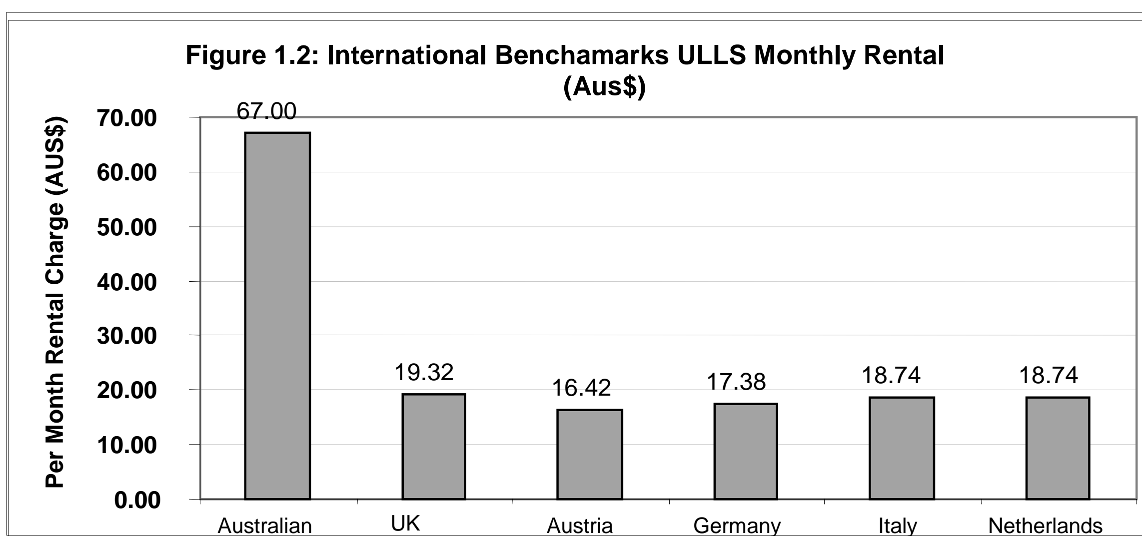
Telstra is engaging in a constructive refusal to supply

1.44 A constructive refusal to supply occurs when the price or the terms upon which the first supplier is willing to supply a service causes the supply of the product by the purchaser to the customer to be impossible or unlikely in the circumstances of the supply. As stated by the ACCC in its Information Paper "Anti-competitive Conduct in Telecommunications Markets":

> "*a constructive refusal to supply inputs [is where] the price charged for these inputs is so high that the downstream producer is unable to trade profitably*

(except, for example, where the prices charged for those inputs are cost-based)”[13].

1.45 The Flexstream service is an essential input into the supply of retail internet services to residential customers by downstream operators such as Excite@Home. This is because the current prices of ULLS makes it uneconomical for Optus to acquire each of the component elements of Flexstream including ULL, transmission and DSLAMs[14], at a price which would enable it to provide competitively priced wholesale ADSL services. Furthermore, new entrants would be unable to achieve the economies of scale and benefits of linesharing that Telstra currently enjoys. A further barrier to entry is presented by the ULLS pricing itself. Telstra’s proposed average price for ULLS is $67 per month, which by international benchmarks is excessive. As figure 1.2 reveals the appropriate price for ULLS is $20 per month.



Source: Oftel, www.oftel.gov.uk/publications/pricing/llup1200.html
Note: All charges are in AUS$ using PPP exchange rates as quoted in the OECD, *Main Economic Indicators*, July 2000.
Telstra’s charges are calculated using a weighted average of Band 1 (25%) and Band 2 (75%).

Telstra’s pricing of Flexstream has an anti-competitive effect

1.46 Telstra’s conduct is in breach of the competition rule set out in Part XIB of the TPA. That is, Telstra’s pricing structure for its Flexstream product has the effect of substantially lessening competition in the market for products dependant on high-speed bandwidth to residential customers, SOHOs and small businesses. Telstra’s failure to offer a viable wholesale product to downstream service providers has meant that many ISP’s such as Excite@Home have been unable to offer an ADSL product. As a result, Telstra is currently the sole player in Australia offering ADSL services to end users on a geographically widespread basis.

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13 ACCC. “Anti-competitive conduct in telecommunications markets”, p.45

14 DSLAM- Digital Subscriber Line Access Multiplexer.

1.47 Moreover, given that Telstra controls the CAN and given the high sunk costs involved in rolling out alternative infrastructure, competitors will be reluctant to enter retail markets offering broadband services. This will have negative consequences for Australian consumers in terms of product availability, choice and pricing. This in turn increases barriers to facilities-based investment and infrastructure-based competition.

Section 46 is inadequate

1.48 Telstra has strong incentives not to lower its price for the Flexstream product or to offer new entrants comparable bandwidth service. Not doing so will foreclose the ability of other carriage service providers to bundle ADSL services with other competitive products, allowing Telstra to monopolise markets for broadband data delivery, and will decrease competition in related markets.

1.49 Despite Telstra's motivation, a section 46 case, regarding this issue, would be difficult to make, given that under a purpose based test, the burden of proof rests on the claimant to present evidence proving an anti-competitive intent. By contrast an effects based test as applied by part XIB would focus on the social welfare implications of the conduct and effects that it will have on the efficient operation of the competitive process. Hence, this is a more appropriate test to apply given the nature of the conduct and the level of information asymmetry that exists, which favours Telstra.

1.50 Furthermore, Telstra would stand to benefit from protracted, drawn-out proceedings, as this would allow Telstra to gain a first mover advantage in the retail market for high speed internet access. Telstra could sign-up the most lucrative customers and by the time a section 46 case came to fruition, the market monopolisation would have been completed. Hence a Part XIB action would prove to be more effective, given that issuing of a competition notice would create an appropriate set of incentives for Telstra to adopt a more appropriate charging structure for its Flexstream product.

Data interconnection case study

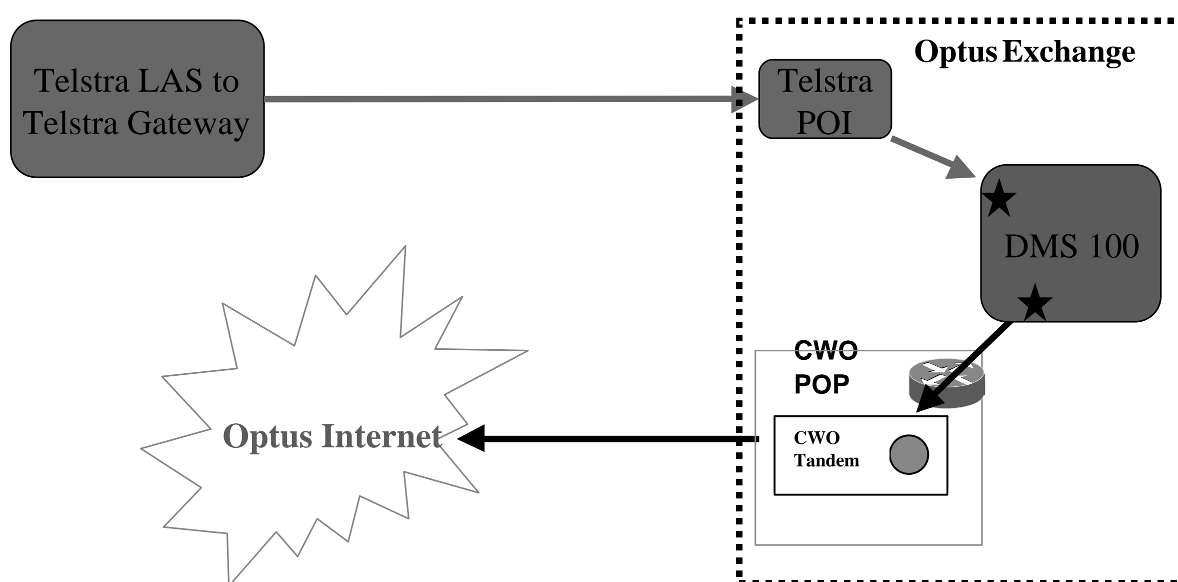
1.51 Another area in which Part XIB may be of use relates to interconnect arrangements for data traffic between the Telstra and Optus networks.

1.52 Currently over 90% of fixed telephony users are connected to Telstra's local loop and therefore, in order to access any dialup internet service provider (ISP), 90% of end-users have to use the Telstra local loop to establish a dialup connection. This gives Telstra significant market power in the market for fixed line call origination services. Optus believes that Telstra is using this market power to adversely affect the ability of competitive ISPs to compete in the markets for both retail internet services and wholesale dial-up services.

Current arrangements are inefficient and costly

1.53 Currently, Telstra purchases a terminating access service from Optus to enable its customers to access ISP's connected to Optus. This service is a mirror of the PSTN model, as shown in figure 1.3, with handover of traffic at the PSTN Point of Interconnect (POI)[15]. These current arrangements are sub-optimal for both Telstra and Optus, as they are costly and result in call service degradation. This result is because long-held data calls are handled inefficiently by trunk switches because they are dimensioned for shorter voice calls.

Figure 1.3: Current PSTN Solution for Data Interconnection



1.54 These arrangements are costly for both Optus and Telstra because it relies on trunk switches, on both sides of the POI, which are designed for voice traffic, and therefore inefficiently handle long held data calls. This leads to excess capacity loads on both Optus and Telstra switches, which is costly to both parties. Furthermore, given the limitations of the trunk switches, interconnection at times of peak capacity may not be achieved for all data calls.

1.55 Compared to Telstra's own architecture, shown in figure 1.4, the current PSTN arrangements are costly. Telstra's internal solution utilises a network access switch (NAS) which is specifically designed to handle data traffic. It is therefore more cost effective than the current PSTN arrangements.

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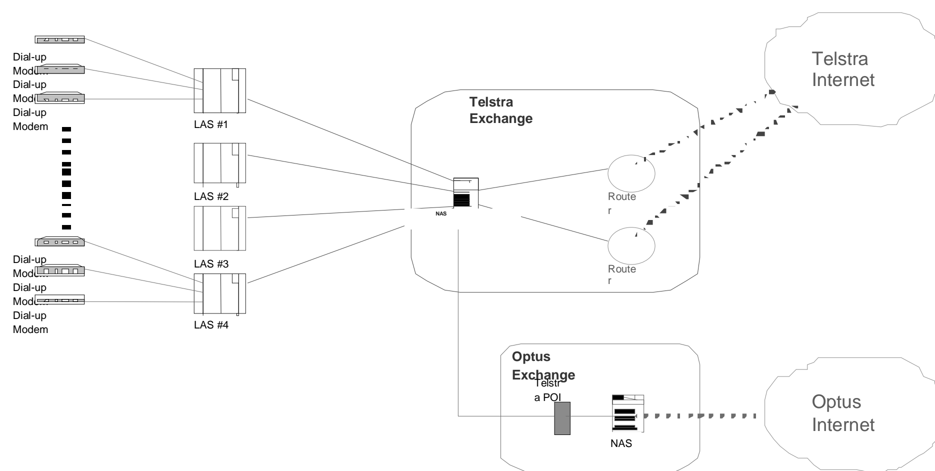
[15] Optus also uses Telstra's ISDN end-to-end solution for ISP connected calls, however this is costly and inefficient compared to the PSTN. Optus is increasing its utilisation of the PSTN solution.

The NAS optimum solution

1.56 To overcome the network inefficiencies and excessive costs associated with the current PSTN arrangement Optus has proposed that it utilise Telstra's internal data service solution with interconnection at the NAS (see figure 1.4). This is a technically feasible long-term solution which optimises the efficiency of hand-over of data traffic and leads to commercial benefits for both parties.

Figure 1.4: The NAS Optimum Solution



1.57 This solution allows Optus to interconnect at the NAS and avoids unnecessary switching on both sides of the POI. This results in several benefits including:

a) a lower capital expenditure requirement due to a reduction in trunk switching capacity because data calls are separated earlier in Telstra's network

b) Telstra's costs will decrease, as data calls need not go through Telstra's tandem switch. Also Optus has offered to reduce termination charges to Telstra if it accepts this solution. Hence, this solution provides Telstra with lower originating network costs and lower terminating access charges.

c) Also there may be operational benefits such as quicker provisioning times.

Optus believes that this proposal represents a win-win solution for both parties.

1.58 However despite the advantages of the proposed NAS optimum solution, Telstra has rejected it. In addition Telstra is refusing to upgrade the PSTN network solution, currently delivered to Optus. The current PSTN network needs to be upgraded so as to handle the excess capacity being experienced on the PSTN network due to the increased number of long-held data calls.

1.59 Telstra's conduct is raising Optus' costs of termination.

Implications for competition

1.60 Telstra has to date failed to offer a data interconnect solution which will allow Optus to achieve the same cost efficiencies and network utilisation that Telstra itself achieves from its own internal service. Going forward this will limit the ability of Optus to grow its ISP business. There are several aspects to this:

a) By rejecting Optus' proposed NAS optimum solution, Telstra is denying Optus the same cost savings that Telstra itself achieves from a priority terminating service for long-held ISP data calls. This limits the ability of Optus to offer a competitive ISP service as it forces a higher cost structure upon Optus, making it harder to compete in downstream retail markets.

b) Telstra's refusal to upgrade the capacity of the trunk switches on its PSTN network will result in service quality degradation, given that at times of peak capacity, interconnection may not be achieved for all data calls due to the limitations of the trunk switches. This will have a differential impact on competing ISPs such as Optus given the higher quality of Telstra's internal solution.

c) The combination of Telstra's refusal to upgrade the capacity of the current PSTN network solution and to offer Optus the NAS optimum solution will mean that as the market for internet access grows, Optus' market share will remain the same and possibly decline.[16] Furthermore, in the medium to long term this will lead to customer churn away from Optus' ISP service, hampering its ability to achieve economies of scale and is likely to have deleterious affects on Optus' brandname and its ability to bundle products.

1.61 Telstra's refusal to allow Optus to access its internal data service, with interconnection at the NAS, causes an anti-competitive effect. Network congestion caused by the current arrangements negatively impacts on Telstra's ability to route traffic, of which a majority is generated from Telstra customers to other carrier networks. Therefore, Telstra's significant market power in the market for local access services provides it with few incentives to offer the NAS optimum solution to competing ISP's, given that doing so will increase their ability to compete with Bigpond's dialup internet service.

[16] Optus' market share would decline if the volume of voice calls were to increase, or if the average hold times of calls were to increase.

Section 46 is inadequate

1.62 Section 46 would not offer an adequate remedy to Optus in seeking to obtain the NAS optimum solution. This is because Telstra's conduct is an example of what the ACCC terms as a failure to "do a positive act". Where there is a failure to do a positive act it is unlikely that a court will infer purpose. Hence without an effects based test the anti-competitive effect of the current problem would be allowed to continue at the expense of the competitive process. Telstra's refusal to upgrade its PSTN network by adding capacity to its trunk switches is also a failure "to do a positive act".

1.63 According to the ACCC the commercial churn and internet peering cases were also examples of failing to do a positive act and that section 46 was inadequate to remedy such conduct.

> *"The effects based test is particularly required where the use of market power is alleged to have substantially lessened competition is in fact a failure to do a positive act. In the commercial churn case, for example, the conduct in question was, amongst other things, a failure to replace an inefficient manual customer transfer process with an efficient automated process. The action taken by the ACCC in the internet peering and commercial churn matters would not have occurred under Part IV."*

1.64 Furthermore as in the case of Flexstream Telstra would stand to benefit from lengthy proceedings. Hence, given that the threshold for a Part XIB action is lower than for injunctive proceedings under section 46 the ACCC would be able to act more quickly under Part XIB than it could under Part IV proceedings. This means that Part XIB is the preferred regulatory instrument.

Telstra's pre-porting case study

1.65 A third area in which Part XIB may be of use relates to how Telstra's pre-porting process causes delay and customer cancellations for business customers.

Telstra's pre-porting process causes porting delays

1.66 Under Telstra's current porting arrangements, if a large business customer wants to port to Optus from Telstra, Optus must first advise Telstra before attempting to port that customer. Telstra then conducts a "pre-port study" (PPS) to determine if it has sufficient network capacity on its network to allow the port to proceed. If the PPS shows that there is sufficient network capacity on Telstra's network, Telstra will advise Optus of this and Optus can then proceed to port the customer. However, if the PPS shows that there is insufficient network capacity on Telstra's network, Telstra will advise Optus that it needs to undertake work to increase its network capacity. According to Telstra, this can take up to 9 months if a new switch is required.

1.67 These pre-porting processes cause porting delays which are unacceptable to most business customers. When a business customer asks to be ported away from Telstra, the recipient carrier is currently unable to provide the business customer with the following information:

- when Telstra will complete the PPS;
- when the actual port will take place;
- accurate timeframes for the completion of the porting process.

Implications for competition

1.68 In a competitive telecommunications environment, most business customers demand short and certain timeframes for porting.

1.69 Telstra's pre-porting process makes it impossible for recipient carriers to provide definite porting timeframes to business customers wishing to port away from Telstra. This acts as a barrier to entry, inhibiting Optus' ability to compete in the business market.

1.70 Most 'cancellations' or customer withdrawals occur when or immediately after the customer makes an enquiry regarding porting to Optus. The inability of Optus to provide certainty as to the timeframes for porting results in many large business customers deciding not to port to Optus. Sales intelligence suggests that a significant number of business customer ports have not proceeded beyond the initial inquiry stage because Optus was unable to provide the customer with certain timeframes for porting.

1.71 Delays have also resulted for residential customers as a result of the inefficient paper-based porting process for line number portability (LNP). It currently takes up to one month to port a residential customer to Optus. Market information suggests that cancellations will increase from 7 per cent to 23 per cent if a customer has to wait one month instead of one week to receive their new service.

Section 46 is inadequate

1.72 In order to overcome the present delays associated with the porting process, Telstra should be required to:

1. proactively upgrade its network capacity in line with forecasts so that network capacity exists to enable the timely porting of residential and business customers;
2. agree to maximum timeframes for completing the PPS to ensure that porting can proceed and that it will not be delayed due to limited network capacity; and
3. agree to maximum timeframes for upgrading network capacity when a PPS determines that there is insufficient network capacity for a port to take place.

1.73 To date Telstra has refused to upgrade its network capacity and has not agreed to maximum timeframes for completing the PPS or for undertaking network capacity upgrades.

1.74 As in the case of the current data interconnect arrangements it is unlikely that a section 46 action would be successful in securing a pro-competitive outcome for business and residential number portability. This is because Telstra's refusal to proactively upgrade its network capacity or to agree timeframes for completing the PPS and for undertaking network capacity upgrades is another instance where Telstra is failing to "do a positive act". As discussed previously where there is a failure to do a positive act it is unlikely that a court will infer purpose. However an effects based test would identify the anti-competitive effect of the current arrangements and would permit the regulator or the courts to act accordingly.

2. Part XIC

Introduction

2.1 This chapter provides follow-up information on the following issues:

(a) Optus' views concerning the Productivity Commission's proposed declaration test for Telecommunications services.

Optus suggests that the declaration criteria for originating and terminating telecommunications services should be a substantial market power test, and that such services should not need to satisfy other proposed declaration tests.

(b) Feedback concerning the wording of the Commission's proposed legislative pricing principles;

Optus proposes pricing principle 1 should either be deleted and or qualified by principle 4 taking precedence where retail price controls hold the retail price of services below cost. Principle 2 is vague and should be deleted.

Commission's proposed declaration test

2.2 This section provides further commentary concerning the Productivity Commission's proposed telecommunications declaration criteria.

2.3 The Productivity Commission's draft report finds that the declaration criteria in Part XIC is vague and provides excessive discretion to the regulator. It also differs from the criteria applying in Part IIIA. The Commission recommends that the criteria be replaced with a new more objective set of requirements, all of which must be met, before the ACCC can declare telecommunications services.

2.4 The Productivity Commission proposes that for a telecommunications service to be declared it must meet all of the following criteria:

(a) the telecommunications service is of significance to the national economy and

i) for a service used for originating and terminating calls, there are substantial entry barriers to new entrants arising from network effects or large sunk costs; or

ii) for a service not used for originating and terminating calls, entry to the market of a second provider of the service would not be economically feasible;

(b) no substitute service is available under reasonable conditions that could be used by an access seeker;

(c) competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;

(d) addressing the denial of access, or the terms and conditions of access, to the service concerned is likely to improve economic efficiency significantly; and

(e) access (or increased access) to the service would not be contrary to the public interest.

2.5 Optus agrees with the Commission's findings that the current declaration criteria is vague and may provide the ACCC with excessive discretion in the declaration of telecommunications services. Concerning the proposed criteria and wording of the Commission's proposed declaration test, this section makes the following points:

1. A substantial market power test should be used to determine the declaration of electronic communication services used in the supply of originating and terminating access.

2. Originating and terminating telecommunications services should not need to satisfy the Commission's proposed tests (b), (c), (d) and (e), or the Commission's proposed "significance to the national economy" test under criteria (a).

3. Test (c) should be removed from the Commission's declaration criteria.

Substantial market-power test for originating and terminating services

2.6 As detailed in Optus' previous submission, we believe satisfaction of a substantial market power test is a necessary and sufficient test to determine whether originating and terminating electronic communications services of a service provider should be declared. This recommendation is made on the basis of the following five points:

1. *It is consistent with international telecommunications law* concerning the tests employed to determine the regulation or otherwise of access to telecommunications carrier networks. For example, European Commission law[17] currently requires carriers with significant market power, in the supply of a fixed telecommunications service, to interconnect their facilities and supply the service on cost oriented terms. The European Review of Telecommunications Competition Legislation proposes a single-

[17] Fixed telecommunications services are regulated under Directive 97/33/EC requiring fixed operators with significant market power to set cost-oriented interconnecting charges. The Directive also requires operators with significant market power to set transparent and non-discriminatory interconnection charges, and implement accounting separation. Accounting separation allows internal transfer prices of incumbent carriers to be rendered visible, allowing regulatory authorities to check compliance with obligations of non-discrimination for vertically integrated operators in the supply of services to competitors with whom incumbents compete in downstream markets. In January 1998 the Commission published best practice interconnect charges 98/155/EC. This was updated by recommendation 98/511/EC to provide best practice prices for 1999, and again updated on 21 March 2000.

tier significant market power test to govern the access regulation of telecommunications services.[18]

2. *Most OECD countries have telecommunications specific access regimes that, in terms of outcomes, regulate according to a substantial market power test*. For example, United States incumbent carriers are regulated by the Telecommunications Act 1996. This requires cost-based interconnection, resale of incumbent retail services according to a retail less avoidable cost approach, and access to unbundled local loop services at TELRIC prices. European Countries are regulated by Telecommunications specific EU Interconnection[19] and Unbundling Directives[20] combined with Telecommunications-specific regulations in member countries. For example, Oftel regulates telecommunications in the United Kingdom using a mixture of telecommunications specific law such as the Telecommunications Act 1984,[21] and industry specific powers to vary telecommunications carrier license conditions. Oftel generally uses a significant market power test in the determination of telecommunications access regulations.

3. *A substantial market power test would more correctly capture areas of market failure*, such as local services resale and access to unbundled local loops, whilst not unnecessarily extending access regulation to competitive markets. The area of most notable significant market failure in telecommunications markets is access to the fixed local loop. All forms of competitive entry, including resale and unbundling, are worthy of pro-competitive government measures whilst this market failure remains.

   As discussed in our previous submission, a danger with the Productivity Commission's current proposed declaration criteria is that it may lead to a scaling-back of regulation in areas currently subject to significant market failure such as unbundled local loop services[22]. This would also put

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[18] The EU currently proposes regulating all telecommunications services under a single-tier significant market power test. See "Commission proposal for a Directive on a common regulatory framework for electronic communications networks and services COM (2000) 393 (OJ C 365 E, 19.12.2000". The EU review is expected to finish by the end of 2001 with the proposals implemented by 2003.

The Commission's most recent work on the practical interpretation and application of the significant market power test is "Proposed New Regulatory Framework for Electronic Communications Networks and Services Draft Guidelines on market analysis and the calculation of significant market power under Article 14 of the proposed Directive on a common regulatory framework for electronic communications networks and services". COMMISSION OF THE EUROPEAN COMMUNITIES Brussels, 28.3.2001 COM (2001) 175.

The specific application of this Directive to fixed network interconnection is discussed in "Proposal for a Directive of the European Parliament and of the Council on access to, and interconnection of electronic communications networks and associated facilities COM(200) 384, OJ C365E, 19.12.2000".

[19] See Directive 97/33/EC.

[20] See, for example, Proposal for a "Regulation Of the European Parliament And Of the Council on unbundled access to the local loop", COMMISSION OF THE EUROPEAN COMMUNITIES Brussels, 12 July 2000, COM(2000) 394.

[21] The UK Telecommunications Act 1984 established Oftel and provides their duty to promote competition and protect consumers. Oftel regulates Telecommunications largely through imposing obligations through changing telecommunications carrier license conditions. Such license modifications can be appealed to the UK Competition Commission. This arguably provides Oftel with greater powers than the ACCC has in Australia because license modifications can be used as a "do something" power.

[22] For example, the wording of test 1 (a) that specifies services used for "originating and terminating calls" suggests ULLS would not necessarily come within the ambit of this test since ULLS is primarily used for the carriage of high speed data services.

Australia out of alignment with current telecommunications regulation applied in most advanced OECD countries — such as the United States, United Kingdom, and Finland.

4. *The ACCC has previously suggested use of a substantial market power test* to determine declaration of telecommunications services.[23] Therefore adoption of such a test would ensure a continuity with existing declaration arrangements whilst aligning the principles of telecommunications access with principles used in other countries and other industries in Australia. In this respect our recommendation may provide an achievable incremental improvement to current Part XIC declaration legislation.

5. *The test is consistent with other sections of the Trade Practices Act*, such as Part XIB and section 46, which require the possession of substantial market power before liability can arise for anti-competitive conduct.

2.7 In summary, there is good international and Australian precedent for the use of a substantial market power test to determine the declaration of originating and terminating telecommunications services.

Originating and terminating services should not have to satisfy other Commission declaration criteria

2.8 As discussed in Optus' previous submission, we believe tests (b), (c), (d) and the "significance to the national economy" test in criteria (a) should not apply to originating and terminating electronic communication services.

2.9 Our reasoning for this is that we believe the proposed tests may be unduly difficult to meet in current areas of significant market failure such as local call resale services and unbundled local loop services. For example, Optus has an HFC network passing 2 million dwellings and presently supplying over 500,000 local access telephony services, and 30,000 high speed internet connections. This suggests test (b) "no substitute service is available under reasonable conditions that could be used by an access seeker" may not be satisfied for either local call resale or unbundled local loop services. In addition, unbundled local loop services (ULLS) arguably may not satisfy the "significance to the national economy" test (a) due to the prospective nature and potential of this service to the national economy.

2.10 Optus believes it is important that ULLS and local call resale regulation is maintained whilst facilities-based competition is still developing and not ubiquitous. In particular, whilst Optus is providing significant facilities-based competition to Telstra in some residential geographic areas, Telstra still retains powerful geographic monopolies in many areas. For example, our market data suggests that Telstra has lost fewer telephony lines to new entrants in CBD and business markets than in the residential market. This, perhaps counter-

[23] See "Declaration of Telecommunications Services, A guide to the Commission's Administration of the Declaration Provisions of Part XIC of the Trade Practices Act 1974." July 1999.

intuitive[24], result has arisen from, among other things, government and Telstra erected barriers to entry, such as:

(1) Telstra's failure to effectively and efficiently provide local number portability for businesses with over 20 lines;

(2) Government failing to prevent building owners from levying discriminatory building access charges on new entrant networks.

2.11 Such barriers to entry mean Telstra is likely to maintain significant market power in many geographic areas over the next five years. Therefore a winding-back of pro-competitive access measures for ULLS and local call resale would likely further entrench and maintain Telstra's market power in these geographic areas. This is because such access regulation can be shown, over a certain range, to have a complementary and stimulatory effect on facilities-based competition.[25]

Winding-back ULLS and LCS declarations would encourage cross-leverage

2.12 If ULLS and local call resale regulation were scaled-back, Telstra's ability to cross-leverage its market power into downstream markets, arising from its control of the key customer access network input, would be enhanced. As discussed in chapter 1, Telstra is instituting this cross-leverage strategy via its wholesale/retail pricing of Flexstream services — where the Telstra retail price ($78 per month including GST) is lower than the wholesale price of the Flexstream service to competitors ($104.50 per month including GST). Hence, removal of pro-competitive access regulation in these areas is unlikely to promote more competitive outcomes or enhance facilities-based competition.

2.13 In summary, Optus believes a substantial market power test is both a necessary and sufficient test for determining the declaration of originating and terminating electronic communication services.

Test (c) should be removed from the Commission's proposed declaration criteria

2.14 Optus suggests the Productivity Commission should remove test (c) from its recommended declaration criteria.

2.15 The Commission's test (c) proposes:

(c) "competition in downstream markets is insufficient to prevent the provider of the service from exercising substantial market power;"

2.16 Our reasoning for the proposed removal of test (c) from the declaration criteria are as follows:

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[24] This result is perhaps counter-intuitive because market data suggests business telephone lines yield higher revenues and have lower costs of supply than residential lines.

[25] See, for example, Optus' submission to the Productivity Commission " Case study on local loop unbundling".

1. In general,[26] downstream competition does not exert a constraining influence on the ability of the owner of an essential input to charge monopoly prices for that input.

2. Even where there is inter-modal competition that may fully constrain the price of retail services,[27] this does not necessarily constrain the owner of an essential facility from setting monopoly prices for upstream inputs.

3. Test (c) does not add to the declaration criteria given the Productivity Commission's proposed tests (b) and (d). For example, if downstream competition does sufficiently constrain the exercise of upstream market power then it would not be possible to satisfy the Commission's test (d) — that declaration will likely "significantly improve economic efficiency". Therefore test (c) is unnecessary given the Commission's proposed test (d).

2.17 In summary, test (c) should be removed from the Commission's proposed declaration criteria.

Commission's proposed legislative pricing principles

2.18 This section provides further feedback concerning the wording of the Commission's proposed legislated pricing principles.

2.19 This section makes the following points:

(a) As discussed in Optus' previous submission, the Commission's cost recovery principle 1 may not promote economic efficiency in circumstances where retail price controls hold the price of retail services below cost. We would therefore advocate the removal of principle 1, and or a further pricing principle that the Commission's fourth principle (the imputation rule) should take precedence over its first pricing principle under circumstances where retail prices are held below cost because of government regulation.

(b) Principle 1 should be further rewritten to provide that "Access prices should generate revenues that, when combined with the net revenues earned from the supply of all other services using the input, are sufficient to meet the efficient

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[26] A case where a downstream firm is more likely able to constrain upstream market power is where the downstream market is also a monopoly, and the sunk costs of entry into both upstream and downstream markets are approximately equivalent. In this case the relatively even or bilateral bargaining power over access should ensure unfettered commercial negotiations achieve reasonably efficient outcomes. As the downstream market becomes more de-concentrated and competitive the market power of the upstream essential facility owner in bargaining with many small downstream providers is likely to increase.

[27] The example alluded to by the Productivity Commission discusses the world market for coal where the retail price is set exogenously by world market forces. Does this mean Australian coal producers will commercially negotiate efficient prices for access to essential rail infrastructure? The answer is not necessarily. The rail owner may set monopoly access prices for rail access, appropriate some of the surplus of infra-marginal coal producer investments, deter some socially beneficial coal production, and earn substantial monopoly rents from the practice. Significant efficiency losses may arise in factor markets where the rail owner is unable to perfectly price discriminate rail haulage prices, for example, because of an inability to prevent resale amongst coal producers of rail haulage capacity.

Telecommunications retail services such as local calls are not generally tradable between countries. This suggests declaration criteria C has limited applicability in the telecommunications industry.

long-run costs of providing the input including a return on investment commensurate with the risks involved;"

(c) Principle 2 is vague and ambiguous as presently worded. We suggest it should be removed in the absence of a clearer principle.

2.20 The Commission proposes the following legislated principles:

"*Draft Recommendation 10.1*

The Commission recommends that the following principles be legislated for telecommunications. Access prices should:

(1) generate revenue across a facility's regulated services as a whole that is at least sufficient to meet the efficient long-run costs of providing access to these services, including a return on investment commensurate with the risks involved;

(2) not be so far above costs as to detract significantly from efficient use of services and investment in related markets;

(3) encourage multi-part tariffs and allow price discrimination when it aids efficiency; and

(4) not allow a vertically integrated access provider to set terms and conditions that discriminate in favour of its downstream operations, unless the cost of providing access to other operators is higher."

The points discussed above are now elaborated.

Principle 4 should take precedence over principle 1 where there are distorting retail price controls that hold the price of retail services below cost

2.21 As previously discussed, legislated pricing principles embodying first best principles may harm economically efficient outcomes where retail pricing is distorted by second best considerations. For example, if retail price controls hold the price of a retail service below cost, an access price requiring full cost recovery of the upstream input will provide less economically efficient outcomes than setting the input price according to efficient component pricing.[28] Optus recommends therefore that the first principle be removed from the Commission's proposed principles.

2.22 If the Commission proposes to retain principle 1, it should be qualified by the further rule that principle 4 (the imputation rule) takes precedence over principle 1 in circumstances where retail price control regulation holds the price of retail services below costs.

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[28] This approach takes the retail price for the service as given and subtracts the input owners avoidable costs from no longer undertaking the downstream activity to determine wholesale prices. Under the circumstances of retail price control constraints this rule provides for the promotion of efficient downstream entry and competition whilst leaving the input provider in an equivalent position.

Principle 1 should be rewritten to provide for cost recovery over the full set of services supplied using the access input, not just regulated services

2.23 Principle 1 should be further rewritten to provide that:

> "Access prices should generate revenues that, when combined with the net revenues earned from the supply of all other services using the input, are sufficient to meet the efficient long-run costs of providing the input including a return on investment commensurate with the risks involved."

2.24 As Principle 1 is presently worded, it could arguably be interpreted that regulated input services must in total recover input costs. However, in telecommunications certain essential inputs such as the customer access network are used to supply multiple services, some of which are price regulated and others which are not. The total set of services supplied using these inputs should contribute to economic cost recovery of the inputs, not just the narrower set of regulated services.

2.25 For example, Telstra's customer access network (CAN) supplies a range of unregulated services such as ISDN, Faxstream, Pay Television[29] and data services. These contribute over $3 billion per annum to Telstra's revenues and should also be required to contribute to the economic cost recovery of the CAN under any regulatory cost allocation/ price setting determinations. Under the Commission's current wording of principle 1, if only regulated services are required to fully recover input costs, then access prices may lock-in monopoly profits in perpetuity from the total supply of regulated and unregulated services that use the access input.

2.26 More importantly, such a principle, as presently worded, could also cause anti-competitive access price squeezes of competitive downstream firms — where regulated services in isolation are required to fully recover essential input costs. For example, if Telstra's retail prices for the CAN recovered the costs of the CAN in total from both ISDN (unregulated) and voice (regulated) services, requiring the regulated access input price for voice services to fully recover CAN costs would cause an anti-competitive price squeeze against Telstra's downstream competitors. Telstra's competitors would have a higher input price for using the CAN for voice than Telstra's own downstream operations.

2.27 In summary, Principle 1, if retained, should be rewritten to provide for cost recovery over the full set of services supplied using the access input, not just regulated services.

[29] The Foxtel cable shares the same trenching infrastructure used for copper cable voice services.

Pricing principle 2 is vague and should be deleted

2.28 The Productivity Commission's Principle 2 says:

> *"Access price should not be so far above costs as to detract significantly from efficient use of services and investment in related markets."*

2.29 It is difficult to ascertain the meaning and economic concepts behind this principle. As presently worded the principle may arguably be interpreted as implying that access prices should be set above economic costs of supply, but not significantly above economic costs.[30] In telecommunications the more relevant threshold question is whether the market is subject to a significant pricing failure such that it can and should be corrected through the setting of regulated access prices.[31]

2.30 If this threshold has been passed, a process that systematically biases regulatory economic cost calculations upwards via principle 2, is unlikely to promote economic efficiency. In particular, such a principle would:

(1) Bias the build/buy decisions in an economically inefficient manner by diverting scarce capital towards uneconomic duplication of incumbent facilities;

(2) Reduce downstream entry and innovation below economically efficient levels;

(3) Cause end user prices to be too high in perpetuity; and

(4) Increase opportunities for anti-competitive price squeezes against new entrants — where access prices are set systematically above economic costs.

These considerations suggest dynamic efficiency is likely to be significantly impaired by a legislative principle that suggests access prices should be set systematically above the economic costs of service provision.

2.31 Therefore, Optus recommends that legislative principle 2 should be deleted.

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[30] If principle 2 implies access prices should be set above economic costs, this then raises further questions about how far above economic costs access prices should be set.

31 In our experience, the principle regulatory problems with access stem from over-reach of the telecommunications access regime (such as mobile, intercapital-city transmission and Pay TV delivery via cable), rather than the setting of incorrect access prices in markets that are subject to significant market failure — such as access to Telstra's copper local loop.

3. Government erected barriers to competition

Introduction

3.1 As discussed in Optus' previous submission to the Productivity Commission, we believe the draft report paid insufficient attention to some key inhibitors of investment in core telecommunications infrastructure. The Productivity Commission's report provides an opportunity to recommend legislative reforms to remove many of these government erected barriers to entry.

3.2 The key government erected inhibitors of investment in core telecommunications infrastructure include:

1. Retail price controls;
2. Barriers to new entrant build-outs such as proposed discriminatory local council charges on new entrant networks;
3. Building access charges levied in a discriminatory manner by building owners on new entrant networks; and
4. Unnecessary regulatory requirements such as the imposition of the Customer Service Guarantee (CSG) on new entrant networks;

This section elaborates further on the last three of these issues, and recommends that the Productivity Commission should recommend the removal of these government erected barriers to entry.

Discriminatory local council charges on new entrant networks

3.3 A number of local councils in New South Wales have made claims against Optus based on section 611 of the Local Government Act, which the councils argue authorises local councils to levy 'an annual charge on … all cable laid, erected, suspended, constructed, or placed on, under or over a public place'. To date, more than 30 local councils have threatened claims. As of January 2001, about 27 local councils had made claims totalling approximately A$12.9 million. Additionally, four local councils in Victoria and two in South Australia have made similar claims totalling about A$1.2 million.

3.4 On 10 November 1998, Optus commenced proceedings in the Federal Court of Australia against councils in New South Wales and Victoria challenging the validity of notices sent by those local councils. In late 2000, the Federal Court found in favour of the councils.

Council charges are discriminatory and breach competitive neutrality principles

3.5 These Council charges are discriminatory for two reasons:

(1) The Councils have discriminatorily targeted Optus' local distribution network, not levying any charges on other utility distribution infrastructure such as electricity, gas and water companies; and

(2) The Councils have targeted Optus distribution network for significantly higher fees per geographic area than the Telstra network.

Both of these practices depart from the principles of competitive neutrality.

3.6 The Councils have levied discriminatory charges on Optus' network. This is because utilities such as electricity networks have generally obtained State Government exemptions from the levying of such charges. The Councils have not attempted to levy charges on other distribution networks such as gas and water. Therefore electricity companies that have rolled-out aerial cable on the same poles occupied by the Optus HFC cable, are not charged any fees by local councils, whereas the Optus HFC network is subject to the current Council charge claims.

3.7 In addition, vis a vis telecommunications providers, the Councils have proposed differential rates for overhead and underground cable. Overhead cable is charged at about twice the rate per kilometre as underground cable. Therefore, since Optus' network is overhead, whereas Telstra's network is predominantly underground, the Council levies are approximately twice as much for Optus verses Telstra per geographic area served. Since Optus' penetration in residential areas served is presently approximately 25 %[32], the Council levies per subscriber are at least 6 times greater for Optus compared to Telstra. Such charging arrangements are a further violation of competitive neutrality.

3.8 On both counts (telecommunications distribution network verses other utilities, and between Optus and Telstra) this discriminatory treatment is inconsistent with the Federal-State Competition Principles Agreement (CPA) 1995.

Productivity Commission Recommendation

3.9 The Productivity Commission should recommend Local Councils be prohibited from charging telecommunication networks for local distribution networks. This principle creates competitive neutrality with the present treatment of other utilities such as electricity, gas, and water.

[32] 500,000 SIOs passing 2.2 million dwellings.

3.10 If any charges are to be levied on utility distribution networks, they should be levied at the Federal level by the Commonwealth Government in accordance with the principles of the CPA. That is all utilities should be charged at the same rate.

Discriminatory building access treatment for new telecommunications providers

3.11 The Parliament's intention in passing the Telecommunications Act 1997 (the Telecoms Act) was to grant carriers rights to access land and buildings for the purposes of inspecting, installing and maintaining telecommunications facilities to provide services to tenants in buildings.

3.12 However, the current legal provisions of the Telecommunications Act 1997 do not achieve this objective. Building owners and managers are undermining new carrier access rights by frustrating access to buildings in an attempt to force new entrants to pay fees before they can provide services to tenants in the buildings. Optus, rather than incur delays, generally pays building owners significant amounts per annum to achieve access.[33] Telstra does not incur this same problem because, given its sunk network, it is already in the buildings and therefore does not have to pay building owners any such building access charges.

3.13 Therefore Optus has a cost base that is higher than Telstra because of these additional charges that are discriminatorily levied by building owners on new entrants seeking access. This is a significant explanatory factor for Telstra losing less market share in CBD and business markets than in residential markets. The building access charges depart from the principles of competitive neutrality because they do not treat Optus and Telstra equivalently.

3.14 The solution to this issue adopted in Hong Kong was a legislative prohibition on building owners charging telecommunications carriers for building access[34].

Recommendation

3.15 The Commonwealth Government should tighten the carrier building access arrangements in the Telecoms Act to ensure carrier building access rights are upheld. In particular, building owners should be prohibited from charging new entrant networks for building access. Any charges that are levied on telecommunications carriers by building owners must be levied in a competitively neutral manner.

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[33] Building owners are seeking to charge the Optus network up to $25,000 per annum for building access; these charges are in addition to compensatory charges already paid for loss of building rental space.

[34] That is a prohibition on charges above compensation for loss of building rental space.

Unnecessary regulatory requirements on new entrant networks such as the CSG

3.16 The Customer Service Guarantee (CSG) includes minimum fault repair, connection timeframes and the requirement to meet appointment commitments for the provision of local fixed network access. If these requirements are not met, providers of fixed network access incur monetary penalties.[35]

3.17 The CSG is Telstra centric in its design specifications. It therefore constrains new entrant carriers to rollout local networks according to the design quality features of the Telstra network. The CSG also differentially impacts on new entrant network providers because fault rates are always higher during the initial construction phase of a network compared to a telecommunications network that has been operational for a substantive period[36]. The CSG therefore discriminatorily limits other telecommunications providers' ability to compete via rolling-out local networks and through product differentiation.

3.18 The CSG increases the costs of providing basic fixed access. Therefore, when coupled with retail price controls that hold the price of basic access below cost, the CSG further undermines new entrants' incentives to rollout fixed telecommunications network infrastructure. In addition, the requirement of the CSG applying to new entrant networks is unnecessary given Telstra is required to comply with the CSG. If a customer is not satisfied with the quality of service provided by a new entrant they could choose Telstra for service.

3.19 The Besley inquiry found the application of the CSG to new entrant investments was unnecessary and had a deleterious effect on the incentives to undertake investment in alternative fixed network infrastructure. The inquiry recommended the CSG not apply to new entrant networks.

Recommendation

3.20 The Productivity Commission should recommend the CSG not apply to new entrant networks.

3.21 The government should consider the complete and progressive removal of the CSG in areas subject to fixed network competition, such as residential Melbourne, Sydney and Brisbane.

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[35] The CSG is likely to be an economically inefficient and outdated government mandated quality specification, especially in urban areas, given the widespread ubiquity of mobile telephony.

[36] For example, requirements to fix telephone faults within specified time period or incur monetary penalties systematically favors old networks that having been operational for a substantive period — where initial design bugs and roll-out imperfections will have been remedied many years ago. This raises the barriers to new entrant investment in telecommunications networks. In addition, the CSG requirement will tend to systematically favor larger fixed networks due to economies of scale in the deployment of personnel to fix faults in a given geographic serving area.

4. Pay-TV programming

Introduction

4.1 This chapter addresses two further issues that arose from the Productivity Commission's hearings:

(a) Whether Foxtel's behaviour in refusing to supply Optus with FoxSports is consistent with the normal profit-maximising behaviour of a monopolist?

(b) FoxSports' statement in its submission implying that it has offered FoxSports to Optus and that agreement has not occurred due to a failure to agree commercial terms for the product.

Foxtel behaviour is not consistent with standard monopoly, profit maximisation models

4.2 Foxtel's current behaviour in relation to exclusive programming is not consistent with standard monopoly, profit maximisation models. Under the standard single price monopoly model[37], the monopolist raises price to the point where marginal revenue equals marginal cost, and then supplies to all consumers willing to pay the monopoly price. The monopolist does not exclude consumers who are prepared to pay the monopoly price.

4.3 In contrast, Foxtel is not prepared to make any offers to Optus regarding the carriage of the FoxSports channels. That is, they are restricting the supply of content to Optus independent of the price we are prepared to pay for that content. They are thereby restricting the class of subscribers available to view the content, independent of "willingness to pay considerations", hence lowering profits to below standard monopoly outcomes.

[37] Under price discriminating monopoly models the exclusion of Optus from carrying the FoxSports content makes even less sense from the perspective of the profit maximizing monopolist. This is because profits can be increased so long as willingness to pay exceeds marginal costs of supply.

4.4 The economics of the above behavior is depicted in figure 4.1.

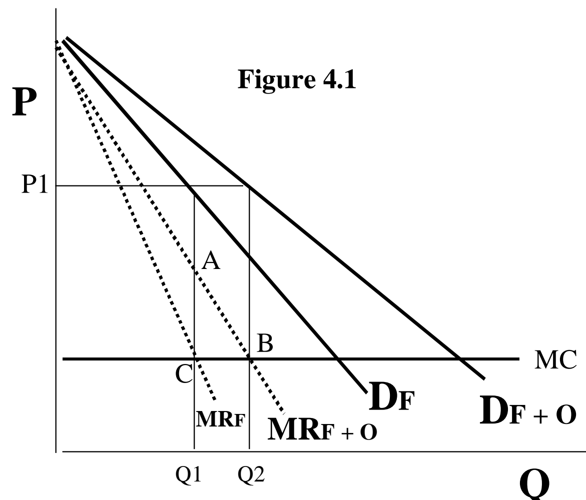


Figure 4.1

4.5 Demand for the FoxSports channels, where Optus is not excluded from carriage, is depicted by demand curve DF+O in the above diagram. The profit maximising monopolist equates MR and MC and will supply quantity Q2 at price P1 in the above diagram. Now, when Foxtel excludes Optus from the carriage of FoxSports (independent of willingness to pay), the class of subscribers able to view FoxSports is reduced to Foxtel subscribers. The demand curve for FoxSports therefore shifts inwards to DF. Output levels are reduced to Q1 supplied at a price of P1. It can be shown that the content providers' profits are reduced from this practice by area ABC.

4.6 Suppose Optus' proposed non-discrimination principle for key Pay TV programming is implemented. It can be shown that even if monopoly prices are being charged to Foxtel subscribers for the content, profits can be increased for the content provider by also making the content available to other delivery platforms at these same monopoly prices. The increased profits are depicted by area ABC in the above diagram, which provides the quantum increase in profits from making the FoxSports channels also available on the Optus platform on non-discriminatory terms. The demand curve for the content shifts outwards the more delivery platforms and subscribers that are able to view the content. Therefore profits can be increased from open programming arrangements because of the higher quantum of subscribers (larger pool of customers) able to purchase the content.

4.7 Hence, we do not believe Foxtel's current behaviour is motivated by or explainable with reference to normal monopoly pricing considerations. Optus believes that it can be inferred from Foxtel's conduct that its intention is to drive Optus out of the market, thereby securing a long-term monopoly at both the wholesale and retail level. Foxtel's behaviour is consistent with the sacrifice of short-run profits to fully execute this long-run monopolisation strategy.

FoxSports content is being withheld from Optus

4.8 FoxSports submission to the Productivity Commission suggests that the reason Optus is unable to carry FoxSports is due to a failure to agree commercial terms with FoxSports. Point 11 of FoxSports submission reads:

> *"We now turn to the curious question of whether content has been withheld and the fervent claim by CWO that it has made several unsuccessful attempts for a considerable period of time to license the FoxSports channels for broadcast on the CWO network. We do not accept that CWO can attribute this to the fact that such content is being locked up. What CWO fails to point out is that these attempts have been unsuccessful because Fox Sports and CWO have been unable to strike a deal for the supply of these channels on commercial terms which will benefit both parties' long term strategic business interests and objectives."*

4.9 This statement is not correct. FoxSports, in commercial discussion with Optus concerning the carriage of the FoxSports channels 1 and 2, have said their exclusivity arrangements with Foxtel prevent them from making an offer for the carriage of the FoxSports channels to Optus on any terms. Therefore, FoxSports have refused to progress the discussions beyond this point. In particular, FoxSports have not offered to provide the FoxSports channels to Optus on any terms, let alone reasonable and non-discriminatory commercial terms of supply.

4.10 In summary, FoxSports presently refuses to supply FoxSports channels 1 and 2 to Optus on any commercial terms.

5. Universal service arrangements

Introduction

5.1 In this chapter, Optus will discuss the universal service arrangements from a broad policy viewpoint, before moving on to the problems we see with the current application of the USO and future problems that may arise with the application of tendering.

5.2 In particular, Optus will argue that:

(a) Funding the USO through taxing competitors holds back competitive infrastructure investment;

(b) Consideration should be given to levying the entire USO on Telstra. This would ensure that the incumbent has the incentive to minimise the costs of the USO, in contrast to the current system; and

(c) Failing this, if the Government wishes to continue to target equity goals in telecommunications, it should fund these equity goals through consolidated revenue.

Is there a rationale for universal service subsidies?

5.3 Before discussing how the USO should be funded, it is worth examining exactly what the objectives of the USO are. Some would argue that the USO serves two purposes — to maximise the penetration of the fixed line network (thereby, through network effects, increasing the value of the network for all subscribers) and to achieve equity goals.

5.4 Optus' view is that the USO actually only addresses equity goals, primarily because fixed line penetration is close to 100 per cent, and is highly demand inelastic. That is, if high cost users had to pay higher prices, it is unlikely they would drop off the network.

5.5 As the Commission itself reports, the penetration of fixed line phones in Australian households stands at 96 per cent — there are 7.5 million fixed residential lines. The fixed line is essentially ubiquitous in Australian households. The few people who do not use fixed lines could generally afford one if they chose — telecommunications services represent a small proportion of households' monthly budget.

5.6 Further, it is unlikely that if the price of access to telecommunications services increased that there would be a significant fall in penetration rates. The Commission reviewed the literature on the elasticity of demand for access in its 1997 staff paper. In a range of estimates, the Commission found that demand was

inelastic, with estimates varying between –0.003 to –0.096. If prices of telecommunications access rose, very few people would drop off the network.

5.7 This suggests that the goal of universal service is not to provide services universally, as this would continue even if prices varied to reflect differences in cost structures across geographical regions. The purpose of universal service seems to be to ensure that services are provided at the same price to all Australians, no matter where they live.

5.8 This goal is purely an equity goal, and Optus does not believe equity goals should be funded through taxing competitors. If the Government believes that some segments of the community should receive access to subsidised telecommunications, it should not attempt to fund these equity goals in a way that taxes competition.

5.9 At the moment, universal service is funded through hidden taxes on consumers, in the form of higher telecommunications charges than would otherwise be paid.

Taxing competition to fund the USO

5.10 The USO is currently funded by the entire telecommunications industry, whether or not they make a profit. That is, as the USO is currently structured, a loss making regional internet service provider (ISP) in Bendigo has to cross-subsidise Telstra's universal service obligations. This despite the fact that Telstra's profit figures dwarf those of the rest of industry combined.

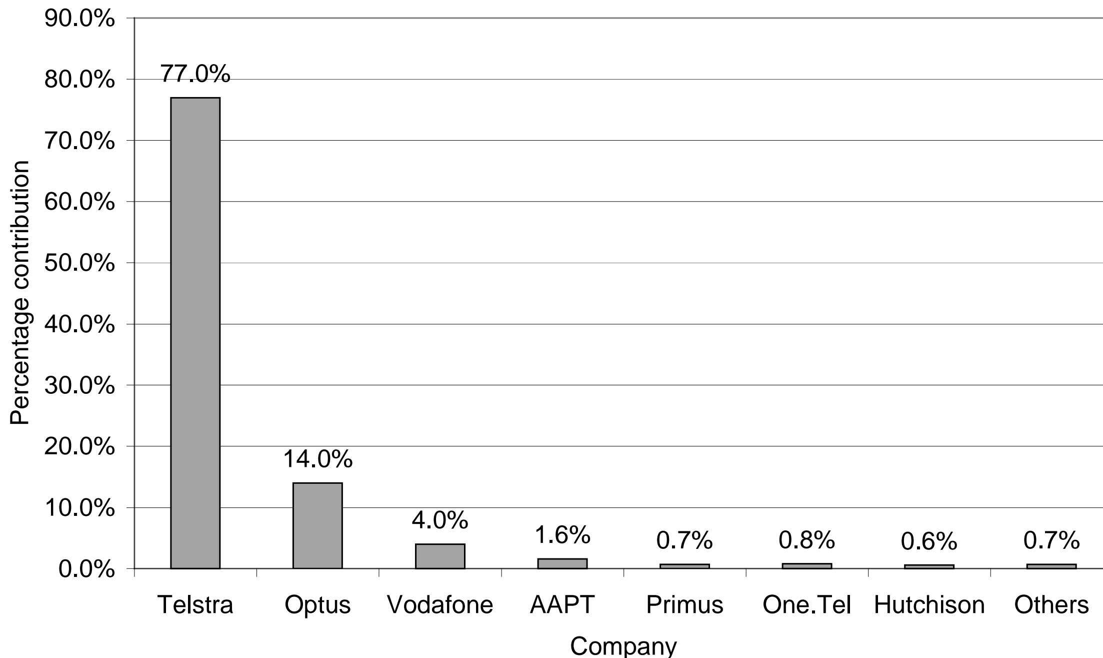
5.11 In Telstra's latest half-year results, it reported a net profit after tax of $2.6 billion, putting it on track to earn over $5 billion for the full financial year. [38]

5.12 A basic tenet of taxation is that it should be levied on an ability to pay basis. This suggests that levying the USO on the basis of revenue is flawed in an industry characterised by large losses.

5.13 As Figure 5.1 shows, under current arrangements, 23 per cent of the cost of the USO to Telstra is cross-subsidised by its competitors, whether or not they make a profit.

[38] Telstra, Half-year report 2001, p. 1

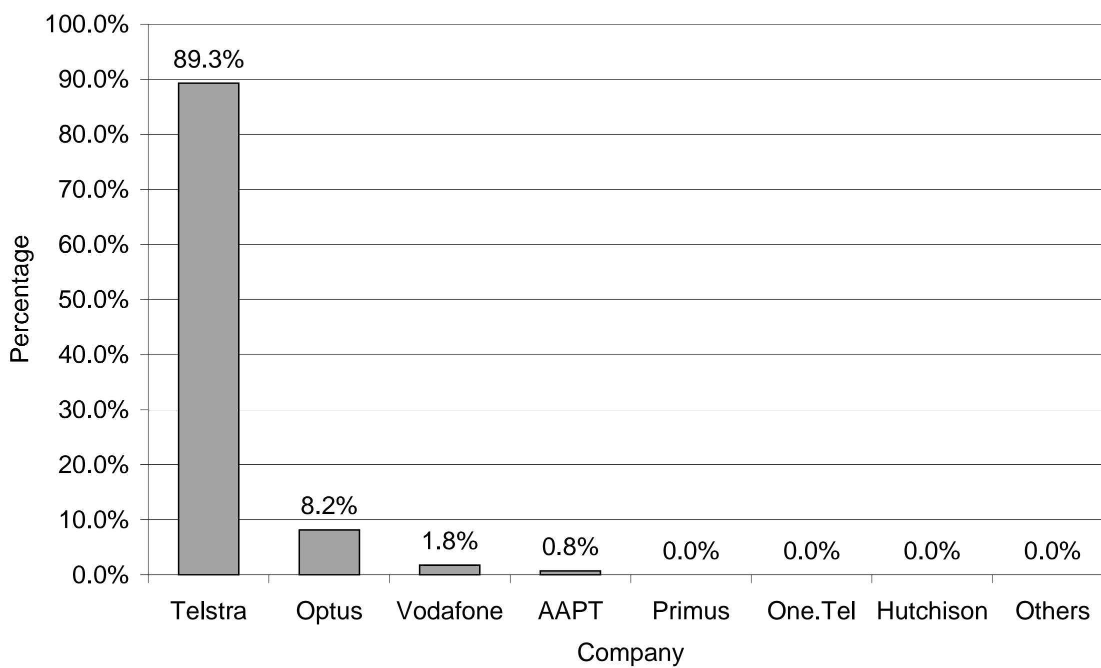
Figure 5.1: USO contributions based on revenue shares



5.14 Optus believes a fairer and more efficient funding mechanism, if Government were minded to continue to cross-subsidise the cost of the USO through an industry-wide fund, would be to use profit shares rather than revenue shares. An estimate of the likely distribution of contributions is shown in Figure 5.2 below.

5.15 Figure 5.2 shows the likely proportions of USO contributions if profit were used rather than revenue. The profit measure used is profit before abnormals and tax. The distribution is based on published financial results for all firms besides Vodafone, who do not publish stand alone results for its Australian operations. Figure 5.2 shows that if USO contributions were based on profits rather than revenue, competitors would cross-subsidise Telstra by a more equitable 10.7 per cent, rather than 23 per cent, as is currently the case.

Figure 5.2: USO contributions based on profit shares



Incumbent funding of the USO — overseas experience

5.16 While a move to funding USO contributions via profit share rather than revenue share would be a step in the right direction, Optus does not believe it would address all of the problems involved in the current USO.

5.17 A large problem would remain — Telstra would continue to have the incentive to over-state the true costs of the USO in an attempt to maximise the cross-subsidy from its competitors. One effective way that this incentive could be countered is to follow the lead of many overseas jurisdictions and levy the entire cost of the USO on the incumbent.

5.18 For this reason, Optus believes that there is a strong case for Telstra bearing all of the costs of the USO. [39]

5.19 In addition to providing the correct incentives for the incumbent to minimise the cost of providing universal service, an incumbent-bears-all-costs model has other advantages. The intangible benefits from being the universal service provider (USP) can be significant and are not appropriately accounted for in current cost

[39] However Commonwealth budget funding is much preferred to a USP bears all model.

modeling. Costs may be very close to the intangible benefits of USP provision. [40] Therefore, a USP bears all cost model may not, in fact, place the USP at significant competitive disadvantage.

5.20 We believe it is important that the USO cost calculation correctly takes into account advantages afforded to the USO provider such as ubiquity, life cycle benefits, and brand image. The commercial benefits of these intangibles are described below:

a) Ubiquity increases the likelihood of winning or retaining the custom of people who move out of uneconomic areas to economic ones;

b) Life cycle benefits arise from an increased likelihood of retaining profitable customers because the USP has served them when they were unprofitable; and

c) Brand image benefits include the enhancement of the USP's brand because it is seen to be serving the community. This gives competitive advantages over other brands not perceived in the same way by customers in competitive areas.

5.21 Oftel has estimated the costs of universal service in the United Kingdom for 1998–99 at between £53–£73 million per annum.[41] Adjusting these figures to the Australian environment, and the higher proportion of customers Telstra claim are uneconomic to serve, the net cost of universal service in Australia would be between $176–$243 million per annum. Extrapolating the Oftel intangible benefit estimate to Australia, produces intangible benefits of between $300–$466 million per year from being an Australian USP. Clearly, these benefits would outweigh the cost of the USO, justifying an incumbent bears all regime.

5.22 The incumbent carriers in United Kingdom (UK), New Zealand (NZ), Sweden and Finland currently bear all USO costs (in NZ, it can pass on some of these costs through interconnect charges). These countries have generally been amongst the world's best performers in terms of delivering low priced/high quality services to consumers.[42] The key consideration that may trigger a change in these circumstances is whether the incumbent carries an unfair burden by bearing these USO costs.

5.23 In NZ the Ministerial Inquiry into Telecommunications regulation found that the incumbent, Telecom, is receiving above average cost-of-capital returns both in urban and rural areas and other businesses.[43] In the UK, British Telecom has shown a significant net benefit to being the Universal Service Provider.

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[40] For example Oftel's original 1997 estimate suggested intangible benefits of USP provision where more than double the costs.

[41] See Oftel 1999 at pg 19.

[42] See for example, Productivity Commission "International benchmarking of Telecommunications Services", 1999 which consistently ranked Finland and Sweden as the best performers of the nine benchmarked countries.

[43] Ministerial Inquiry Into Telecommunications, 27 September 2000, Access to Electronic Services, page 4 of Chapter 9.

Equity goals should be financed from consolidated revenue

5.24 If the Government is not minded to require Telstra to meet the costs of the USO, the next best alternative is to fund the USO through consolidated revenue.

5.25 There seems to be no reason why special telecommunications subsidies for groups favoured by universal service should exist as a separate regime outside the means tested, targeted general welfare programs.

5.26 Optus believes that universal service subsidies should be funded out of consolidated revenues for two main reasons:

a) If the benefits of universal service subsidies were tied to transparent and real costs, then the level of universal service is likely to be more rational;

b) Telecommunications companies represent an economically inefficient and narrow funding base to achieve broad equity goals. Taxation is the appropriate funding mechanism to fund the pursuit of equity goals.

5.27 Optus believes large consumer gains would result if the tax based were broadened from the current reliance on telecommunications carriers' eligible revenue to the wider funding base of the Commonwealth budget. Current policy design is inconsistent with the traditional objectives of public finance theory. The tax base is narrow, easily and arbitrarily avoided, and unduly taxes those firms seeking to introduce competition into the telecommunications industry.

5.28 The tax base is inadequate, and cannot be used to fund extensions of the USO. The money would be better collected and audited by the ATO than by the ACA. The current arrangements are inconsistent with the goal of promoting competition in telecommunications markets.

Current funding base is horizontally inequitable and arbitrary

5.29 Optus believes the current eligible revenue funding base meets none of the objectives or criteria of a well designed public revenue raising scheme. In particular, the scheme is not horizontally equitable because the taxing base is narrow and arbitrary. For example, currently two firms can supply exactly the same goods to consumers with one being liable for USO tax, and the other being not liable because it is not registered as a carrier. More importantly, telecommunication firms pay the tax whereas non-telecommunication firms do not.[44]

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[44] It is sometimes argued certain groups should pay more tax because they receive more benefits from the hypothicated expenditure the raised revenue is spent on (Benefits Taxation). This essentially misses the point concerning the conceptual separation between taxing and spending in public finance theory. The task of taxing policy is to raise revenue in as economically efficient and fair manner as possible – **and this is independent of what the money is spent on**. The task of expenditure policy is to spend the given amount raised on the projects most socially valued. Indeed taking to its logical extreme the 'Benefits Taxation' argument essentially reverses or

5.30 The taxing base is subject to easy and essentially arbitrary avoidance. For example, a firm supplying Voice Over Internet Protocol (VOIP) telephony using IP transmission will escape the USO levy by classifying the service as a content, rather than a carriage, service. Firms bundling internet content, email and voice services can lower the amount of USO levy by unduly allocating most of the bundled revenue streams to non-voice services.

5.31 For carriers supplying bundled Pay TV and telephony services it can be difficult separating out the telephony component of revenue streams for the purposes of eligible revenue.

Current arrangements are vertically inequitable and inconsistent with the goals of competition policy

5.32 The current eligible revenue arrangements do not approximate a value-added tax. The scheme is vertically inequitable because it does not tax carriers according to their relative profitability or ability to pay. For example, for 2000-2001 Optus will be required to pay Telstra over $45 million in USO levy. Yet Optus profit for 2000-2001 of $460.5 million[45] is a mere 7.8% of Telstra's most recently reported profit (EBIT before abnormals) of $5.9 billion for the year end 30 June 2000[46].

5.33 Current arrangements do not approximate a VAT, in part, because eligible revenue (ER) does not allow carriers to deduct their internal or self-sourcing input costs or inputs purchased from non-carrier firms. Therefore the ER base is not a value added tax or a profits tax. It is a revenue tax. Revenue taxes have a disproportionate or vertically inequitable incidence on new firms who are, initially, not generally profitable in the start-up phase of operations. In addition, monopoly providers who earn excess profits do not pay a correspondingly higher amount of tax according to these profits; rather, they pay according to their revenue. Hence the current ER scheme is essentially inconsistent with the major goals of competition policy and the Telecommunications Act 1997 to promote competition in markets because it taxes new carriers unduly and unfairly.

5.34 VAT and revenue taxes are very different. The different incidence can be illustrated by the following example. Suppose carrier A supplies local call services wholesale (local call resale) to carrier B at 20 cents per call. Carrier B's retailing costs are 7 cents per call, and carrier B sells the service retail at 25 cents. Hence carrier B makes a loss of 2 cent per call on the service since total costs = 20 + 7 cents per call, and revenue is 25 cents per call. Under a profits or value added tax carrier B would not be liable for tax since the service is loss–making. However, under current ER arrangements the carrier earns net eligible revenue of

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undoes the initial government goals pursued through fiscal policy expenditure: for example, the unemployed pay more tax to fund unemployment benefits, or rural people pay more tax to fund the telecommunications USO.

[45] CWO Financial Report

[46] Telstra, Annual Report: 2000, http://www.telstra.com.au/investor/docs/2000-review3.pdf

(25 –20)= 5 cents per call and is liable to pay USO levy on eligible revenue of 5 cents per call.

5.35 Optus believe replacement of the current ER base with a more genuine VAT base or 'profits' tax administered by the Australian Tax Office would be preferable to current arrangements. This should be accompanied with the base-broadening measures discussed below in this submission. We believe this may be close to the 'unequal sharing' arrangements canvassed in the DOCITA discussion paper. Such arrangements would better achieve vertical equity.

Administratively Cumbersome

5.36 The current eligible revenue arrangements designate an inappropriate government institution to collect the tax. The ACA is required to audit telecommunications carrier's ER returns and collect the tax. The ACA is not well resourced or skilled to perform this function. In any event, the task is essentially duplicated by the more appropriate government authority, the Australian Taxation Office.

Revenue Inadequacy

5.37 The current ER is an inadequate taxing base. If the government is genuinely committed to increasing USO obligations the current ER base will not sustain increased revenue requirements. The high effective marginal tax rates associated with the current base mean that if the rate is further increased total tax receipts may well decrease.

5.38 The current narrow tax base creates other pernicious distortions in relation to revenue adequacy. In particular, the benefits and incentives to engage in avoidance and evasion of the tax are large: the tax paying culture is undermined. And there is little commitment amongst carriers to fulfil the government's USO policy objectives because the funding base is excessively narrow and unfair.

Current taxing base is narrow and economically inefficient

5.39 The current ER base violates the basic principle of economic efficiency in raising tax revenue: tax bases should attempt to be as broad as possible.[47] All taxes create welfare losses for consumers because they introduce a tax wedge between production cost and the consumer price – hence some socially efficient consumption does not occur because of this tax wedge[48]. It can be shown that this

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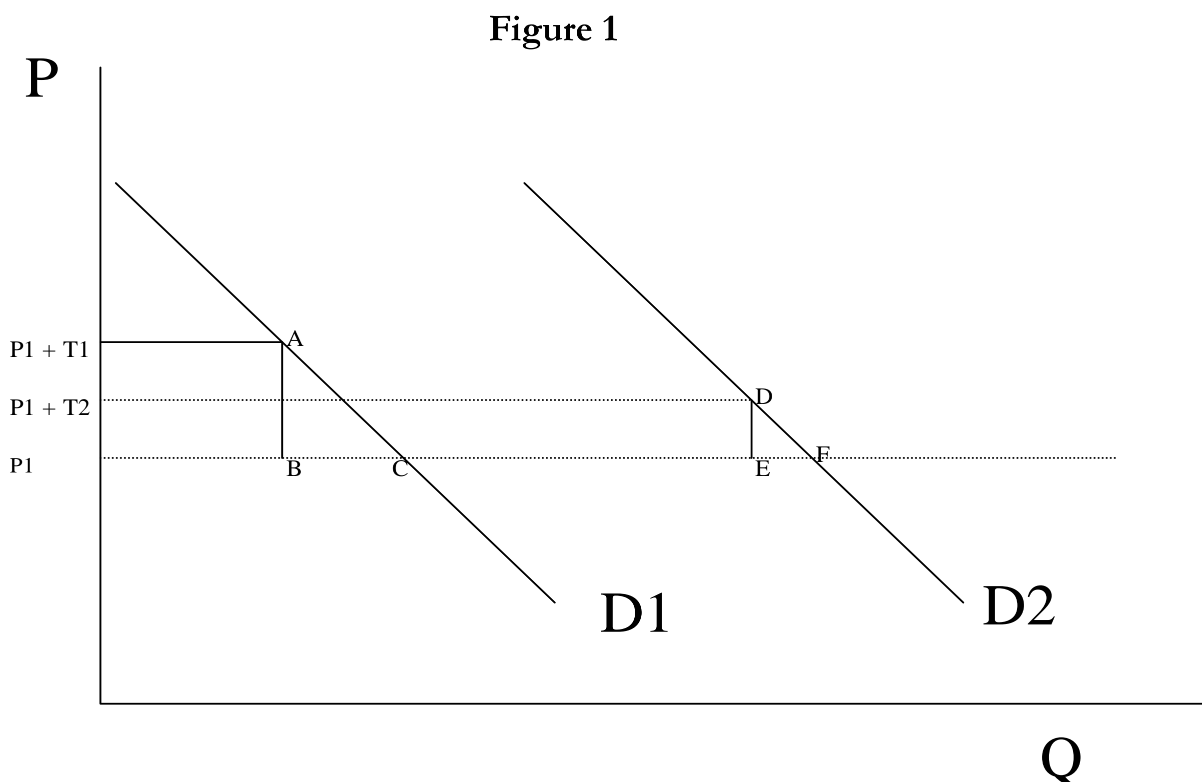
[47] For a good discussion of the economic efficiency gains from tax base broadening see Head, J.G "The Comprehensive Tax Base Revisited", Finanzarchiv, 40 1982, pp 193-210.

[48] Of course, the traditional justification for taxation is the gains from government expenditure of such taxes exceed the losses from the revenue raising exercise. Hence net benefits are positive. As discussed in all traditional economic literature on this issue, the raising of revenue by government, and how such money is spent, are clearly separate exercises, and conceptually separate from a social welfare perspective: The task of tax policy is to ensure a given amount of revenue is raised in the least distorting manner; while the task of expenditure policy is to ensure that, given the amount of revenue raised, it is spent by government on the goods and services most valued by society. Hence it can be shown that a broader tax base is strictly preferable to a narrow based tax in raising revenue – **and this is independent of what the raised revenue is actually spent on.**

welfare loss is directly proportional to the square of the tax rate imposed on the goods. This is the famous Harberger formula for the welfare loss caused by taxation. It can be shown that the excess burden (welfare loss) of a tax = ½ E T 2, where E is the elasticity of the demand curve and T is the tax rate.[49]

5.40 Hence broadly based taxes are preferable to narrow based taxes in raising a given amount of revenue because they create less welfare loss for consumers. Given a certain amount of revenue to be raised, if the tax base is doubled, the same amount of revenue can be raised with a halving of the tax rate. And the distortion to consumer consumption decisions (or tax wedge) and consumer welfare loss is lowered to one quarter of previous levels. This is depicted in the diagram below:

Figure 1



Initially a tax of T1 is placed on the narrow-based set of goods depicted by demand curve D1. The welfare loss of the narrow-based tax is area ABC. Tax revenue is (P1 + T1, A,B, P1). The tax rate can be halved to T2 if placed on the broader base of goods represented by demand curve D2[50]. The welfare loss from the lower tax rate is reduced to DEF = ¼ ABC.

5.41 The telecommunications industry accounts for less than 15 per cent of Australia's total GDP[51]; hence the current eligible revenue funding base is 85 per cent more

[49] See Harberger, A.C "The incidence of the Corporation Income Tax', Journal of Political Economy, 70, 1962, pp 215 –240.

[50] Area (P1+T2, D,E,P1) = Area (P1+T1,A,B,P1).

[51] There are several methods for measuring the percentage tax base of the telecommunications industry to the whole economy: either by value or by revenue. The measures chosen here are conservative. The telecommunications industry is up to 15 per cent of the economy

narrow than the Commonwealth budget. If the current funding base was replaced with Commonwealth budget funding the effective marginal tax rate consumers currently pay to fund the government's USO policy could be lowered to 15 per cent of current levels. Since consumer welfare loss varies with the square of the marginal tax rate, that is such welfare loss increases more than proportionately with increasing tax rates, consumer welfare loss could be reduced to 2.3 per cent of existing levels through tax base broadening.[52]

5.42 Whilst it is difficult to quantify the excess burden or welfare loss caused by the current narrow base, Optus preliminary estimates suggest a loss in the order of $50 million per year from the narrow taxing base. Given the 2.3% factor identified earlier, this welfare loss could be reduced to about $1 million per year through base broadening to the Commonwealth budget. Thus a pure gain to consumers of $49 million per annum is available through tax base broadening.

5.43 Commonwealth budget funding also has the advantage of being the only mechanism whereby the USP has appropriate and economically efficient incentives to sustain adequate investment and improve services levels to all users. Under current arrangements, Telstra has incentives to degrade the quality of service supplied to rural consumers. However under Commonwealth budget funding such incentives are reversed because the threat of withdrawal of such funding by government if certain quality standards are not met would provide excellent motivation for carriers to maintain and improve rural service standards. Rural consumers would be the biggest winners. The approach, especially when accompanied by competitive auction of the USO, is also competitive neutral between carriers.

Appeal of USO costs

5.44 The Commission recommends that:

> *"The power to determine the aggregate universal service levy should lie with the ACA, rather than the Minister, and provision should be made for full merit review of determinations by the Australian Competition Tribunal."*

5.45 Optus supports this recommendation

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according to its percentage share of value of telecommunications firms on the stock market. The industry is 5 per cent of GDP by revenue: Industry revenue is approximately $25 billion and Australia's GDP in Financial year 1998-99 was $593 billion.

[52] This is simply derived by comparing the welfare loss with different effective marginal tax rates: $15^2/100^2$ x 100 per cent.

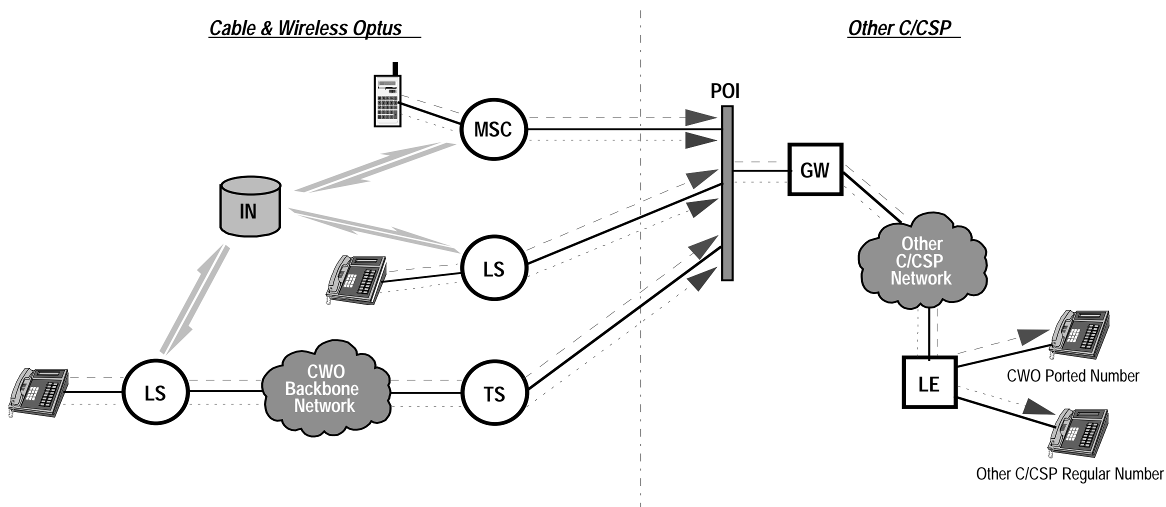
6. Specific Questions from PC

This chapter responds to a number of specific questions raised by the Productivity Commission in its public hearings into Telecommunications Competition Regulation and in subsequent discussions with Optus, where those issues are not dealt with in other sections of this submission:

1. *What solution does Optus employ to provide LNP and what factors influenced its choice of solution?*

Optus has employed an Intelligent Network (IN) solution to provide LNP. The diagram below illustrates the Optus LNP network architecture, which is based on an IN solution, in relation to handling LNP calls to ported and non-ported numbers:

Figure 6.1: Optus Network Architecture for LNP



All calls originating on the Optus network to number ranges where LNP is implemented will invoke an enquiry to it's Intelligent Network (IN) layer developed for LNP to determine the correct destination network for the call. Calls to Optus numbers ported to a Recipient network and calls to non-ported numbers on the Recipient's network in its portable number ranges are handled in the same way by Optus.

Optus chose an IN solution to provide LNP for the following reasons:

1. Reliability - the Optus IN solution for LNP is built with an inherently high level of reliability and availability, with duplicated IN operational databases to ensure that failure of a single element of the IN will not be noticeable to customers;

2. Equivalent service – the Optus IN solution ensures that Optus complies with its regulatory obligation to provide equivalent service for calls to ported numbers;

3. Cost effectiveness – an IN solution is the most cost-effective way of providing LNP whilst also complying with the equivalent service criteria;

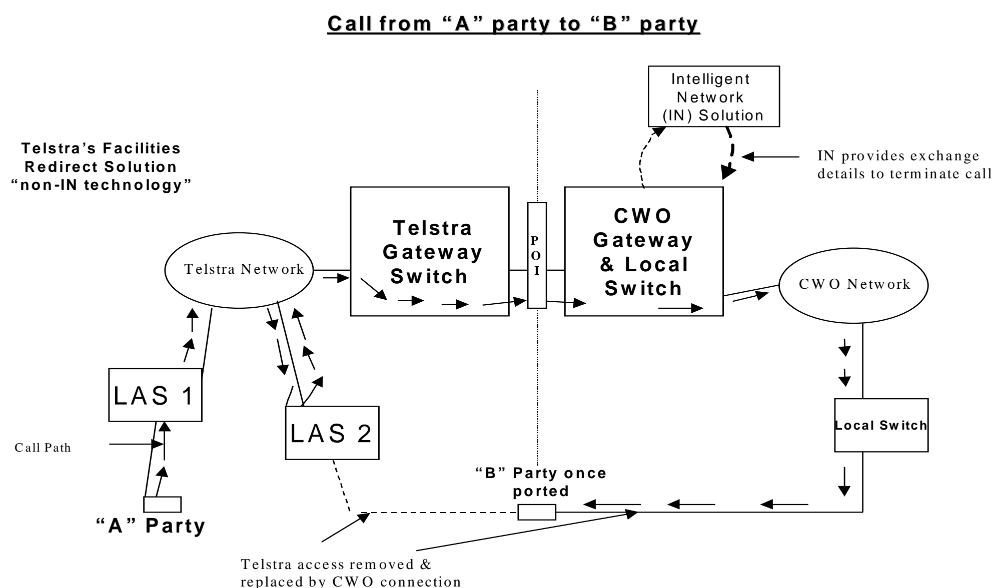
4. Network efficiency – an IN solution ensures that calls are handled efficiently. Telstra's LNP solution involves "trombone trunking" of calls which causes unnecessary network congestion.

Facilities Redirect (FRD)

Telstra has employed an FRD solution for LNP. FRD results in increased traffic passing between Telstra's local exchanges and gateway exchanges ('tromboning').

For customers with large volumes of in-bound traffic FRD actually concentrates the traffic on the terminating local exchange. The diagram below provides an overview of how FRD works.

Figure 6.2: Telstra's Network Architecture for LNP



Optus has always maintained that such a solution could not meet the ACA's equivalent service criteria for a number of reasons including:

- A network that implements facilities redirect must send all calls to numbers ported on to a separate recipient network via the donor or some other network. This requires all calls to those ported numbers to be switched through additional transmission and switching stages when compared to calls to numbers that are not ported. Facilities redirect does not provide a sufficient level of network capability to enable such calls to be sent directly to the network with the ported number in a manner that provides equivalent quality. In particular, since FRD uses more network elements for calls to ported numbers, which will block, the probability of successful delivery of calls to ported numbers is necessarily less than for the calls to non-ported numbers. Optus believes that this violates the concept of equivalent service.

- There will always be a difference in the post dialing delay experienced by calls to ported and non-ported numbers in portable number ranges when facilities redirection is used.

- The call paths taken by calls to ported numbers in portable number ranges will always involve additional switching and transmission under facilities redirect. Thus there will always be lower transmission quality and grade of service parameters for calls to ported numbers verses non-ported numbers.

- Delay and echo will be adversely affected by facilities redirect because of the additional switching and transmission links required for calls to ported numbers. The additional switching and transmission links involved in the call will add to the delay on the connection.

- The ability of a network to offer the same services and features to its directly connected customers with ported and non-ported numbers depends upon its capacity to switch calls between those customers entirely within its own network. Some services and features require additional signaling capabilities between the originating and terminating local exchanges. This signaling capability cannot be provided if the call is switched through another network, as occurs with facilities redirect.

- Facility redirect requires the use of additional switching and transmission resources in order to direct a call to a customer with a ported number. Facility redirect is therefore not efficient in directing calls to the customer with a ported number.

- The facilities redirect solution is likely to have a limit on the number of carriers and CSPs that can be supported and this limit is well below the number of carriers and CSPs operating in the Australian market. Telstra indicated to Austel's Local

Number Portability Study Group, when facilities redirect was initially proposed, that fewer than ten networks could be accommodated with this solution.

- Absent FRD, Optus can provide full geographic number portability. Geographic number portability enables a customer to change location and keep the same number. Optus' IN solution means that Optus customers can enjoy the benefits of geographic number portability. However, Telstra's use of FRD prevents Optus from offering geographic number portability to customer who have ported from Telstra to Optus because FRD itself cannot support geographic number portability. Telstra's FRD solution means that Telstra routes calls according to that number's local exchange location. If the ported customer moves outside that local exchange area, Telstra will be unable to route calls to that number. Because Telstra is unable to support geographic number portability, it prevents Optus from offering it to Optus customers who have ported from Telstra.

The US Federal Communications Commission (FCC) prohibited incumbents installing FRD type solutions due to violation of equivalent service, and mandated IN solutions for incumbent CSPs. The FCC, in its First Memorandum Opinion And Order on Reconsideration 97-74 "In the matter of Telephone Number Portability", stated:

> *"The use of number portability methods that first route the call through the original service provider's network in order to determine whether the call is to a ported number, and then perform a query only if the call is to be ported, would treat ported numbers differently than non-ported numbers, resulting in ported calls taking longer to complete than unported calls. This differential inefficiency would disadvantge the carrier to whom the call was ported and impair that carrier's ability to compete effectively against the original service provider."*

The ACCC, in its draft guide on pricing principles for LNP, also noted that:

> *"Facility redirect is therefore not likely to be a solution capable of providing full LNP".*

The ACA is responsible for setting equivalent service criteria and enforcing the obligation to provide equivalent service for calls to ported numbers. Optus requested that the ACA review each CSP's technical solution to ensure that each one meets the equivalent service criteria. Instead, the ACA allowed the industry to self-assess its compliance with the equivalent service criteria. Based on Telstra's self-assessment, the ACA advised that Telstra's FRD solution met the equivalent service criteria.

2. Transferable ownership of numbers – in its draft report the Productivity Commission has outlined three types of costs incurred with the provision of number portability. Two of these costs arise as a consequence of a customer's decision to

port their number. Are there incentives for carriers to compensate customers to avoid these costs?

As pointed out in our previous submission, Optus believes that the significant costs of providing portability are incurred when setting up the initial back office, network and IT systems to support number portability. After that fixed cost is incurred, the actual cost of porting the customer is negligible.

In relation to the call conveyance and customer transfer costs identified in the Commission's draft report, Optus provides the following estimates:

- *Call conveyance costs* – Optus uses an IN solution which treats calls to ported and non-ported numbers equivalently and therefore, the additional call conveyance cost for calls to ported numbers amounts to $0;

- *Customer transfer costs* – Optus estimated customer transfer costs as part of the process of determining which technical solution to adopt for LNP. Optus adopted an IN solution, which we believe is the most efficient technical solution for LNP. Optus estimated that, by using an IN solution, customer transfer costs would amount to no greater than $1.80 per number.

Given these estimates, Optus believes that there is no incentive or reason for carriers to "buy back" the customer's number to avoid having to port the number. The economist, Ronald Coase[53], has argued that markets will not develop where transaction costs exceed the gains from trade. Optus believes that carriers would not "buy back" customer numbers because the transaction costs of doing so would exceed any potential gain.

Given the current porting delays caused by Telstra's pre-porting process, Optus believes that business customers already undertake an informal evaluation of the value of their existing telephone number when they learn that porting of business numbers can take up to 10 months. If a business customer believes that the discounts being offered by the new carrier exceed the value of their existing telephone numbers, they are likely to abandon their existing numbers in exchange for connecting to their new carrier at an earlier date.

In any event, under the current system, the donor carrier bears the cost of porting the customer[54]. Optus fully supports the current system as it encourages carriers to adopt efficient systems for number portability.

Telstra has unsuccessfully argued that it should be able to recover porting costs from the recipient CSP. The ACCC, when setting pricing principles for local number portability, ruled that donor CSPs should not be allowed to recover call conveyance and

[53] Coase, R.. 1937, 'The nature of the firm', Econimica, 4, pp.386-405.

[54] Telstra does charge recipient CSPs for after hours porting and number validation.

transfer costs from the recipient CSP. The Commission, in its draft report, concurred with the ACCC's view that allowing the donor CSP to recover such costs from the recipient CSP would create an incentive to employ a solution that has high call conveyance and customer transfer costs.

Given the above, Optus does not see any benefit in reopening costing issues associated with number portability.

3. *Please provide details on whether or not donor carriers currently impose fees on customers wishing to port.*

Optus is not aware of any fees currently imposed by donor carriers on customers wishing to port. However, Telstra does impose the following fees on Optus for LNP:

Pre-port Number Validation Charge	**Charge**
Small Complex Batch <= 100 Numbers	$168.00 per batch
Complex Batch larger than 100 Numbers	$294.00 per batch
Extended Hours Porting Charge	**Charge**
'Simple' Ports (mostly residential customers)	$2.50 per number
'Complex' Port Batches (mostly business customers)	
1-5 Numbers	$97.50 per batch
6-20 Numbers	$121.00 per batch
21-100 Numbers	$247.00 per batch
101-200 Numbers	$345.00 per batch
Very Large (more than 200 Numbers)	$780.00 per batch

Outside Extended Hours Porting Charge	**Charge**
Simple Ports	N/A
Complex Port Batches	
1-5 Numbers	$180.00 per batch
6-20 Numbers	$180.00 per batch
21-100 Numbers	$297.00 per batch
101-200 Numbers	$395.00 per batch
Very Large (more than 200 Numbers)	$830.00 per batch
Charges for Port Rejects due to Telephone Number/Account Mismatch	**Charge**

Reject due to Telephone Number/ Account Mismatch	$1.25 per number
Associated Secondary Reject (Complex only)	Nil
Charges where Port Rejects Exceeded 10% of Monthly Volume per category	**Charge**
Simple Reject	$5.00 per number
Complex Reject	$16.00 per number
Charges for Reversals	**Charge**
Reversal	$50.00
Charges for Emergency Returns	**Charge**
1-5 Numbers	$150.00 per batch
6-20 Numbers	$500.00 per batch
21-100 Numbers	$1,500.00 per batch
101-200 Numbers	$2,250.00 per batch
Very Large (more than 200 Numbers)	$2,250.00 per batch

Telstra is able to impose these charges on recipient CSPs because Telstra claims the ACCC pricing principles on LNP did not specifically rule on these types of charges. These charges are an indication of what would happen if Telstra were allowed to impose fees on recipient CSPs for all porting scenarios.

Recommendations

The Productivity Commission should recommend the following:

1. The ACCC should be given the responsibility for determining whether or not each CSP has an equivalent service portability solution;
2. The ACCC be given powers to write porting process codes requiring carriers to install efficient porting processes; and
3. Donor CSPs be prohibited from charging recipient CSPs for porting.

Pre-selection

4. In its draft report, the Commission noted that customers often forget or cannot be bothered to dial carrier selection codes and, for that reason, call by call carrier selection is an imperfect substitute for pre-selection. By the same reasoning, could pre-selection with call-by-call override be considered an imperfect substitute for multi-basket pre-selection?

Optus is concerned that the Commission's overview of pre-selection on page 14.2 may give readers the incorrect impression that all calls are handled by the incumbent if the customer does not pre-select or use override codes. Pre-selection and override codes work in the following way:

- customers can pre-select to another CSP in writing or over-the-phone (verbal churn);

- if a customer pre-selects to another CSP, pre-selectable calls will be billed by that CSP;

- instead of pre-selecting a certain carrier for all pre-selectable calls, a customer can use override codes for particular calls;

- if a customer does pre-select to a particular CSP, the customer can still override the pre-selection by using override codes on a call by call basis

- where a customer does NOT use pre-selection or call override, the calls will be billed by that customer's **infrastructure/access line provider** - not necessarily the incumbent. For example, where the customer is directly connected to the Optus network, if the customer does not pre-select or use call override, Optus (not the incumbent) will bill that customer for all pre-selectable calls.

Call override allows customers to react immediately to price discounts. The Commission has stated in its draft report that customers often forget the override codes or cannot be bothered dialing those codes. If this is correct, Optus believes that it may be because there is not sufficient price differentiation to make it worthwhile for customers to remember and be bothered to dial the override code.

Optus believes there would be similar consumer apathy towards multi-basket pre-selection. Optus is not aware of any customer requests for multi-basket pre-selection.

Significant problems still exist in relation to multi-carrier preselection. Optus believes that consumers are not yet receiving the full competitive benefits of multi-carrier preselection because many products are still not pre-selectable. For example, the ACA has granted Telstra an exemption from having to provide pre-selection to its Macrolink customers until June 2002. For competitive parity reasons, Optus obtained a similar exemption for its comparable product, Multiline.

The table below provides an overview of Telstra and Optus' business customer products and the availability of pre-selection and/or call override.

PRODUCT	PRESELECTION AVAILABLE?	OVERRIDE TO OPTUS AVAILABLE?
On-Ramp 2 Light Call Plan	Yes	Yes
On-Ramp 2 High Call Plan	Yes	Yes
On-Ramp 2 MN (Multiple Number) Service	Yes	Yes
On-Ramp 2 Line Hunt Service	Yes	Yes
On-Ramp 2 DID (Direct InDial)	No, services supported by an Indial product are not preselectable	Yes
On-Ramp Xpress (Data product only)	No	No
On-Ramp 10, 20, 30	No	Yes
Telstra's Macrolink	No	No
Telstra's Microlink	No	No
VPN Off-Net calls (calls made without invoking a virtual private network feature)	Yes	Yes
VPN On-Net calls (calls made using virtual private network features)	No	No
Centrex Off-Net calls (calls made without invoking a centrex feature)	Yes	Yes
Centrex On-Net calls (calls made using a centrex feature)	No	No
Optus' Multiline	No	No
Optus' Direct line	Yes	Yes
Optus' Business line	Yes	Yes
Services with RTM facility	No	No
Duet Services (virtual additional numbers)	Yes	Yes
Indial Products (if unable to make outgoing preselectable calls)	No	No

Optus believes that it is more important to fix the current problems with multi-carrier pre-selection before introducing a new form of pre-selection. For example, the ACA has recently released a discussion paper seeking industry comment on various issues including whether or not Virtual Private Network (VPN) "on-net" calls should be pre-selectable.

Telstra recently advised that it was not able to provide pre-selection for VPN "on-net" calls. Prior to this, Optus had upgraded its systems to allow for pre-selection on VPN services. When Optus sought clarification from the ACA on this issue, the ACA decided to open the issue up for public discussion. Telstra VPN customers who are wanting to pre-select to other CSPs must first wait for public discussion and ACA guidance on the matter. Areas of uncertainty such as this should be clarified before entering into discussions about multi-basket pre-selection.

5. Please provide further detail on potential asymmetric application of pre-selection requirements.

As stated in our previous submission, Optus believes that the requirement for pre-selection should be modified to apply only where a carrier has substantial market power in a fixed network. Carriers without substantial market power should not be required to provide pre-selection or call override.

The requirement for pre-selection in the absence of market power has the undesirable effect of reducing facilities-based investment and competition.

The precedent for the targeting of regulation at companies with significant market power (SMP) is consistent with European Directives. European Parliament Directive 98/61/EC which was adopted on 24 September 1998 required the introduction of carrier pre-selection by at least all fixed network operators with **significant market power** as of 1 January 2000.

The EU deems operators to have significant market power if, either individually or jointly with others, it enjoys a position of economic strength affording it the power to behave to an appreciable extent independently of competitors, customers and ultimately consumers. Finland, France, Netherlands have all adopted this approach by requiring only those CSPs with SMP to provide pre-selection.

Further information on the EU pre-selection requirements can be found at:

http://europa.eu.int/ISPO/infosoc/telecompolicy/en/tcstatus.pdf

http://europa.eu.int/ISPO/infosoc/telecompolicy/en/userguide-en.pdf

http://europa.eu.int/ISPO/infosoc/telecompolicy/en/97480en.doc

One of the fundamental purposes of regulation should be to restrain the use of substantial market power which results in anti-competitive outcomes. Symmetrical treatment of industry participants with differing levels of market power serves only to exacerbate existing inequalities between their respective levels of market power.

Australia, having taken a symmetrical approach to telecommunications access and interconnect regulation, is facing complex problems as a result. As Telstra, the incumbent, has a ubiquitous fixed network, any infrastructure built by a new entrant necessarily duplicates the existing infrastructure of the incumbent and the end users have a choice between networks and services. If the new entrant has no market power in the relevant wholesale market, it cannot control wholesale prices or adversely impact

market dynamics in the downstream markets by refusing supply — customers would simply revert to Telstra's network.

As Professor Hausmann observed to the ACCC when it was developing its Access Pricing Principles:

> *"Regulation in telecommunications should only be used when potential market power needs to be controlled. Regulation imposes significant costs due to decreased innovation. No economic reason exists to regulate the access prices of a new entrant because the new entrant cannot have market power. Regulating the new entrant will lead to less investment, less competition, less innovation and harm to consumers. No other country has regulated access prices of the new entrant. It would be a serious economic mistake for Australia to engage in such misguided regulation".*

The current symmetrical pre-selection requirements in Australia lack the trigger of substantial market power to ignite pre-selection obligations and realise competitive outcomes.

Economic thinking now recognises that equal legal treatment can actually lock in or exacerbate existing inequalities between the regulated entities. A uniform set of rules governing all players equally is, while being a long-term goal of regulation, impractical. This is because the need to create some form of pro-competitive policy for new entrants needs to be activated to facilitate competition.

As the OECD has commented:

> *"[An objective of regulators can be] moving towards a non-discriminatory policy (a "level playing field"). Regulators in countries with a pro-competitive policy argue that a completely uniformed set of rules governing all players equally (and a practical minimum of such rules) is the ultimate long range goal of regulation. In practice, this is generally not a practical option under conditions prevailing today or likely in the near future, because of the need to create some form of discrimination in favour of new entrants..........thus, the practical choice concerns how much emphasis the regulator will give to non-discrimination as a near term goal relative to the goal of creating conditions where new, competitive carriers can be established"*[55].

A decision by Optus to directly connect a customer is based on the expected revenue from all services (voice, data, Pay TV and internet) used by that customer. The payback period is related to the total revenue spend from that customer. The costs to connect a customer outweigh the revenue from basic access and local calls from a single telephone line.

In relation to high revenue business customers, approximately 60 per cent of revenue flowing from a directly connected building is pre-selectable. That is, at any time,

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[55] Muller, **International Experiences in Competition and Regulation and Telecommunication Industries** (1996).

customers in that building can pre-select to another CSP, thereby diverting up to 60 per cent of revenue to another CSP.

The current pre-selection requirements not only impact on a new entrant's decision to invest in future infrastructure but also impact on a new entrant's ability to maintain its existing infrastructure.

Optus targets buildings where revenue is sufficient to make an acceptable return on investment. However, if customers in that building pre-select to another CSP, the revenue may no longer be sufficient to justify maintaining the infrastructure.

Shareholder interests require Optus to seriously consider removing the direct connection where a customer pre-selects all long-distance services to another CSP in situations where we can no longer make an acceptable return on our investment. The customer would then return to using the incumbent's infrastructure. It is unlikely that another new entrant would directly connect that customer unless it had some assurance that the customer was unlikely to pre-select.

Recommendations

The Productivity Commission should recommend:

1. CSPs not be required to implement multi-basket preselection; and
2. Preselection requirements be modified so as to apply only where a carrier/CSP has substantial market power in a fixed network.