Cost-Benefit Analysis and Review of Regulatory Arrangements for the National Broadband Network

Telecommunications Regulatory Arrangements
Consultation Paper for the Purposes of Section 152EOA of the Competition and Consumer Act 2010

Submission by iiNet

1. INTRODUCTION

The panel conducting a Cost-Benefit Analysis and Review of Regulatory Arrangements for the National Broadband Network (**the Panel**) has issued a consultation paper entitled: *Telecommunications Regulatory Arrangements Consultation Paper for the Purposes of Section 152EOA of the Competition and Consumer Act 2010* (**the Consultation Paper**). This submission is from iiNet in response to the Consultation Paper.

The Panel has previously issued a Regulatory Issues Framing Paper (**the Framing Paper**) and iiNet has provided a response to the Framing Paper (**the Framing Paper Submission**). Background information about iiNet and information about why the issues being considered by the Panel are of crucial importance to iiNet was included in the Framing Paper Submission. iiNet welcomes the opportunity of responding to the specific issues raised in the Consultation Paper.

2. SCOPE OF THIS SUBMISSION

Under the Panel's terms of reference, the Panel is required to undertake the review (**the Statutory Review**) required by section *152EOA of the Competition and Consumer Act 2010* (**CCA**). This requires a review of the operation of Part XIC of the CCA (**Part XIC**) and Division 2 of Part 2 of the *National Broadband Network Companies Act 2011* (**NBN Companies Act**) and related statutory provisions.

The Consultation Paper divides its consideration of the issues arising into two parts. Part 1 discusses the following matters that relate to Part XIC:

- Possible alternative approaches to Part XIC;
- Functional focus of Part XIC;
- Part XIC and the concept of 'significant market power';
- Part XIC and vectored VDSL 2;
- Declaration;
- Standard forms of access agreements;
- Standard access obligations;
- Access determinations;
- Binding rules of conduct;
- Special Access Undertakings;
- Ministerial pricing determinations; and
- Access agreements and hierarchy of terms.

Part 2 of the Consultation Paper discusses the following matters that relate to the NBN Companies Act:

- Supply of eligible services on a wholesale-only basis;
- NBN Co's ability to supply to utilities;
- NBN Co ability to deal with end-users;
- Restricting NBN Co to the supply of Layer 2 services;
- Supply of other goods and services; and
- Restrictions on investment activities.

This submission sets out iiNet's response to the discussion in the Consultation Paper of each of the above matters. In addition to this submission, iiNet has also provided a report from Frontier Economics (**the Frontier Economics Report**) which sets Frontier Ecomonics' findings in response to what iiNet believes to be three key issues. These three issues relate to:

- what the object of the telecommunications access regime should be;
- who the regulator should be; and
- whether NBN Co should be permitted to discriminate between access seekers.

3. SUMMARY OF SUBMISSION

Consistent with iiNet's views expressed in the Framing Paper Submission, iiNet submits that the basic structure and concepts in Part XIC are sound and should be maintained. In particular, iiNet believes the following fundamental aspects of Part XIC should be retained:

- the objects of the telecommunications access regime should be to promote the long term interests of end users (**LTIE**) (this issue is considered in sections 4 and 8 below);

- the ACCC should administer the telecommunications access regime and should have the power to declare services and set terms and conditions of access (including by means of access determinations and binding rules of conduct) where it is in the LTIE to do so (this issue is considered in sections 4, 5, 8, and 12 below);

- access providers of declared services should be required to comply with standard access obligations and the scope of regulation should not be limited to access providers with significant market power (this issue is considered in sections 6 and 10 below); and

- NBN services (and services that are in competition with NBN services) should be provided on a non-discriminatory basis (this issue is considered in section 10 below).

That said, iiNet acknowledges that there is scope to improve and refine the telecommunications access regime. iiNet has identified the following improvements that should be made:

- The problems arising from the 'Part XIC hierarchy' and a similar legislative hierarchy under the facilities access regime under Schedule 1 of the Telecommunications Act 1997 (**Telco Act Access Regime**) should be fixed (this issue is considered in section 5.2 and section 9 below);

- Specific provisions that deal with the problem of vectored VDSL2 should be included (this issue is considered in section 7 below); and

- The acceptance criteria for a special access undertaking should be rationalised (this issue is considered in section 13 below).

As regards NBN Co, iiNet submits that:

- NBN Co should continue to be restricted to the supply of eligible services on a wholesale-only basis and this restriction should be tightened (this issue is considered in section 16 below.

- NBN Co should not be permitted under any circumstances to supply services directly to end users (this issue is considered in section 18 below); and

- NBN Co should not be permitted to the supply services above Layer 2 (this issue is considered in section 19 below).

4. POSSIBLE ALTERNATIVE APPROACHES TO PART XIC

As acknowledged in the Consultation Paper, the Statutory Review was added into Part XIC in the context of amendments that were made in 2010 and 2011. Accordingly, the Consultation Paper envisages that these amendments are likely to be the key focus of stakeholders' responses to the Consultation Paper. Nevertheless, the Consultation Paper recognises that stakeholders may wish to raise more fundamental issues, including alternative approaches to the existing framework under Part XIC.

iiNet submits that due to the natural monopoly characteristics of a fixed line ubiquitous telecommunication network and the nature of telecommunications markets and services, a model where the regulator is able to declare services and set terms and conditions for those services where it is in the LTIE to do so, is the right model. The superiority of the LTIE objective is discussed further in section 8 below and section 2 of the Frontier Economics Report. Furthermore, as pointed out in the Framing Paper Submission, moving away from the current model prior to the completion of Telstra's structural separation and the rollout of the NBN will create unnecessary cost and disruption to industry.

iiNet submits that the basic structure and concepts in Part XIC are sound and, importantly, have the ability to adapt to changing circumstances. For example, declarations of particular services can be varied, revoked or left to lapse if they are no longer required to promote the LTIE.[1]

As regards who the regulator should be, iiNet submits that the ACCC should continue to be the regulator for the telecommunications access regime, having built up valuable experience and knowledge over the years. iiNet is aware that a criticism that is sometimes made of the ACCC by Telstra and/or its lobbyists is that the ACCC hindered infrastructure development by Telstra by setting below cost ULLS and LSS prices. iiNet submits that such criticisms are unfounded. On a number of occasions, the ACCC's decisions on ULLS and LSS pricing were upheld in both merits review and judicial review proceedings.[2] Furthermore, the Frontier Economics Report includes findings that support a conclusion that the ACCC's pricing of declared services has allowed for the recovery of prudently incurred costs.[3]

In light of the above, iiNet respectfully submits that the Panel can best add value by concentrating on issues that relate to improving and fine tuning Part XIC rather than expending time and resources on considering alternative models or inventing new ones.

5. FUNCTIONAL FOCUS OF PART XIC

The Consultation Paper identifies the issues under this heading as being whether Part XIC should give greater emphasis to access to lower level service functionality (i.e. network access services) and the co-ordination between Part XIC and the facilities access regime in the Telco Act Access Regime. iiNet's view on these issues is set out below.

The scope of declaration under Part XIC currently includes any listed carriage service and any service that facilitates the supply of a carriage service.[4] This is very broad. The scope of declared services includes resale services and network access services. It also extends to facilities access services that are also subject to the Telco Act Access Regime (although no such services have been declared to date). This means that there is potential overlap between Part XIC and the Telco Act Access regime.

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[1] One exception that arises from the changes made in 2010 is that the ACCC cannot vary or revoke the layer 2 bitstream service declaration – section 152AO(4).

[2] See *Application by Telstra Corporation Limited ABN 33 051 775 556 [2010] ACompT 1 (10 May 2010); Re Telstra Corporation Limited (ACN 051 775 556) [2006] ACompT 4 (2 June 2006); Telstra Corporation Ltd v Australian Competition & Consumer Commission [2008] FCA 1436 (19 September 2008); and Telstra Corporation Limited v Australian Competition and Consumer Commission (includes corrigendum dated 27 July 2009) [2009] FCA 757 (17 July 2009)*

[3] Please see section 3 of the Frontier Economics Report.

[4] Section 152AL(1) of the CCA.

As regards the focus and utility of the access regimes under Part XIC and the *Telecommunications Act 1997* (**Telco Act**), iiNet submits that:

- the declaration power under Part XIC should continue to have broad scope because it gives the regulator the ability to maximize competitive outcomes where that is necessary to promote the LTIE; and

- the Telco Act Access Regime suffers from a fundamental defect that needs to be fixed.

Each of these points will be considered in turn.

5.1 The ability to maximize competitive outcomes

iiNet submits that it is unlikely that competition based on network access services (for example the declared Unconditioned Local Loop Service (**ULLS**)) would have developed without the existence of declared resale services which allowed access seekers to build sufficient scale in order to make the necessary infrastructure investments in order to compete using the declared network access services. Furthermore, due to a number of factors (including technical issues such as those arising from the use by Telstra of 'RIMs' and 'Pair Gains'), network access based competition on Telstra's copper network is not feasible in all locations. In light of this, iiNet submits that declared resale services and declared network access services currently both have valuable roles to play. In this regard, iiNet agrees with the following views of the ACCC in its draft report relating to the current fixed line services review:[5]

> *The ACCC considers that the LTIE will be promoted by continued declaration of the resale services, that is, the wholesale line rental (WLR) service, local carriage service (LCS) and public switched telephone network originating access (PSTN OA) (pre-selection and override) services.*
>
> *The ACCC considers that the declaration of resale services will allow access seekers to compete effectively in building or maintaining their customer bases on a national basis during the transition to the NBN.*
>
> *The ACCC considers that the network access services, and services supplied over alternative networks, are limited substitutes for the resale services in supplying fixed voice services. The substitutability of the ULLS for the WLR service is limited by the limited geographical footprint of access seekers' exchange equipment and the substantial costs of investing in expanding their footprint. In addition, the NBN rollout will increasingly reduce the commercial viability of further access seeker investments in copper-based infrastructure. Alternative networks, such as Optus' HFC network, similarly have a limited geographical footprint.*

[5] ACCC, Fixed Services Review – Declaration Inquiry Public inquiry into the fixed line services declarations Draft Report December 2013, at p viii.

> *The ACCC considers that continued declaration of resale services will promote the LTIE by promoting competition in retail markets where access seekers do not have their own exchange equipment or alternative network infrastructure. It will also encourage the efficient use of, and investment in, infrastructure by avoiding inefficient investments in infrastructure by access seekers and by promoting efficient use of Telstra's copper network.*

iiNet submits that particular regard should be had to the conclusion that the continued declaration of resale services will avoid inefficient investment in infrastructure in the transition to the NBN (i.e. one of the benefits of the LTIE test is that it rightly focuses on *efficient* investment and not just investment per se). As regards the likely outcome if resale services are no longer declared, the ACCC has formed the following preliminary view in the current fixed line services review:[6]

> *As noted by AAPT, and others submitters, if the declaration for resale services was not extended, Telstra would have the incentives to either cease the supply of WLR or LCS services or supply these services on unfavourable terms and conditions. The extent to which Telstra actions would have an effect on competition would depend on the availability of substitutes for these resale services in the wholesale market and fixed voice services in the retail market.*

As is noted in the first extract from the ACCC's draft decision above, the network access services are only limited substitutes for resale services. However, this does not mean that resale services should always remain declared. iiNet acknowledges that once the transition to a ubiquitous NBN has been completed, it may no longer be necessary for there to be any declared resale services if a competitive wholesale market for the supply of those services on the NBN is in existence. However, this does not require any specific change to the focus of Part XIC. The current broad focus of Part XIC leads to an appropriate level of flexibility which allows the ACCC to adapt its approach according to changing circumstances. This process of adaptation is clearly evident in the approach taken by the ACCC in the current fixed line services review, where the ACCC has formed the following preliminary view:[7]

> *The ACCC considers that it is appropriate to exclude resale services provided using NBN infrastructure from the scope of regulation. Telstra, AAPT, iiNet and Macquarie Telecom submitted that resale services provided using NBN infrastructure should not be regulated, and no party submitted in favour of regulating resale services provided using NBN infrastructure. The proposed WLR, LCS and PSTN OA service descriptions have been amended to reflect this.*
>
> *NBN Co will provide basic access services on regulated terms pursuant to its Special Access Undertaking. In addition, NBN Co provides services on a wholesale only basis and is subject to non-discrimination provisions.*

[6] Ibid, at p.52.
[7] Ibid at p.viii

The ACCC received evidence that a competitive aggregation market is likely to develop in supplying resale services over the NBN. Small retail service providers are expected to be able to buy competitively priced resale services in this market.

5.2 The defect with the Telco Act Access Regime

In iiNet's experience, a wholesale telecommunications provider will not voluntarily provide services to a wholesale customer without a written contract being in place that governs the provision of those services. For ease of expression, a contract that governs the supply of wholesale telecommunications services will be referred to as a **Wholesale Contract**.

Under the Telco Act Access Regime, the ACCC has no power to make upfront terms of access as it does under Part XIC[8]. Instead, the Telco Access Regime operates under the more traditional negotiate/arbitrate model. Therefore, in the event that an access provider offers unreasonable terms of access to an access seeker, the access seeker's regulatory recourse would be to seek an arbitration.[9]

However, amendments that were made to the Telco Act by the *Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Act 2010* (**the CCS Telco Act Amendments)** have the effect of giving precedence to Wholesale Contracts over arbitrated terms of access in the same way that the Part XIC hierarchy gives precedence to access agreements over regulated terms. The defects of the Part XIC hierarchy were discussed in section 6 of the Framing Paper Submission and are further discussed in section 9 below. However, the situation under the Telco Act Access Regime is worse than under Part XIC because the ACCC has no power to make upfront terms under the Telco Act. Therefore, the effect of the CCS Telco Act Amendments is to deliver the worst of both worlds for access seekers because in order to obtain regulated terms under the Telco Act Access Regime, an access seeker must still use the old negotiate/arbitrate model (i.e. the ACCC does not have the power to make any upfront terms under the Telco Act, so no regulated terms will be in existence when the access seeker is negotiating with the access provider). However, inconsistently with the old negotiate/arbitrate model, any arbitrated terms that are forthcoming will be overridden by any inconsistent contractual terms. Given that ACCC arbitration decisions may need to deal with complex issues and it can take up to two years for a final decision to be made, delaying access while waiting for regulated terms is not a commercially realistic option for an access seeker.

Therefore, the Telco Act Access Regime allows an access provider to maintain its ability to rely on unreasonable terms of access (including the

[8] Note that the reference to a power to make 'upfront terms of access' iiNet is to a power to make terms and conditions of access that are capable of being applicable without an arbitration.
[9] The ACCC is the default arbitrator under the Telco Act Access Regime but it is possible for the parties to agree on a different arbitrator.

ability to charge monopoly rents) that are immune from regulatory intervention for a very long time. This can be done by offering a Wholesale Contract with the following terms on a take it or leave it basis:

- A minimum term of x years (e.g. 10 years).
- A term that confirms that any ACCC arbitration decision is of no effect.
- No ability for the access seeker to terminate the Wholesale Contract for convenience.

iiNet submits that an access regime that permits such an outcome is clearly broken and needs to be fixed. The most obvious way to fix this is to repeal the CCS Telco Act Amendments that caused the problem in the first place.

Although the Telco Act Access Regime is technically outside the scope of the Statutory Review, iiNet submits that consideration of this issue is within the scope of the Panel's broader terms of reference.

6. PART XIC AND THE CONCEPT OF 'SIGNIFICANT MARKET POWER'

The Consultation Paper moots the idea of whether Part XIC should focus on parties with significant (or a substantial degree of) market power (**SMP**) rather than being of general application as it is at present. iiNet submits that given the particular characteristics of telecommunications infrastructure and markets, limiting Part XIC to access providers who have SMP is likely to reduce the ability of Part XIC to deliver outcomes that maximize benefits for end users in circumstances where what have been referred to as 'mini monopolies' develop. iiNet believes that the following statement in the Consultation Paper neatly summarises the point (emphasis added):

> *Furthermore, and depending on decisions taken on other regulatory matters, it is possible that network owners may have a monopoly (at least once a contract for providing a network has been let) in the supply of services in localities even though they do not have SMP either nationally or regionally; new developments on the fringes of metropolitan areas are one example of this scenario; large apartment blocks are another. If Part XIC only applies to providers with SMP, and the relevant market is defined in wide geographical terms, then access seekers may not have an opportunity to supply retail services in those areas and end-users may have no choice of service provider,* ***though it may be that the ex-ante competition to provide the facilities (for instance, in a new estate) in itself protects consumers from the abuse of market power.***

As regards the emphasized part of the extract, it would in iiNet's respectful view be unsafe to rely on any potential ex ante competition to deliver effective and on-going protection for consumers from monopoly behaviour because there would only be, at best, weak incentives for developers to require carriers to agree to provide open access to their networks before being permitted to install their networks at a development.

7. PART XIC AND VECTORED VDSL 2

The Consultation Paper is seeking views from stakeholder on whether existing provisions can adequately deal with the issues arising from the use of vectored VDSL 2 or whether new statutory arrangements are required. iiNet notes that the problem for competition that arises from the use of vectored VDSL has been neatly summarized by Communications Alliance as follows:[10]

> *To reap the maximum performance benefits of vectoring and prevent service instability (e.g. dropouts) no more than one provider can offer vectored services within each cable sheath. This effectively means that there can only be one provider of VDSL2 network services in a node serving area or within a multiple dwelling unit or business centre development. This could be a wholesale-level provider, giving the opportunity for open access to enable other providers to offer services through the node.*

Given that it is unlikely to be efficient to duplicate such networks, iiNet agrees with Communications Alliance that an effective way to deal with the issue is to have specific statutory arrangements that make such networks wholesale only and open access. This could be achieved by making appropriate amendments to the level playing field provisions in Parts 7 and 8 of the Telco Act.

8. DECLARATION

The section of the Consultation Paper dealing with declaration includes a request for views on whether the LTIE test needs to be revised. As stated in sections 4 and 5 above, iiNet does not believe that any fundamental changes are required to Part XIC. In particular, iiNet believes that the LTIE test is appropriate and is superior to any other proposed test. iiNet submits that the LTIE test is superior to a test based merely on promoting investment because the LTIE test implicitly acknowledges that investment and competition are not ends in themselves but are the means to the end of achieving a greater good. This issue is addressed in detail in section 2 of the Frontier Economics Report. iiNet's views on the focus and scope of declaration are set out in section 5 above.

[10] Communications Alliance submission in response to the Framing Paper, at p.4.

9. STANDARD FORMS OF ACCESS AGREEMENTS

The Consultation Paper raises the question whether the SFAA processes work effectively and, if not, how they can be improved. iiNet submits that the concept of an SFAA can play a very useful role in addressing the problems that arise from the Part XIC hierarchy. The problems with the Part XIC hierarchy were discussed in detail in section 6 of the Framing Paper Submission. iiNet's proposed solution to these problems is as follows:[11]

- Where the access provider is required by the SAOs to provide access to a declared service, the access provider must offer to provide access on the basis of a standard set of terms and conditions (**the Standard Offer**).

- The Standard Offer must be consistent with any special access undertaking and regulated terms in force (any inconsistencies between these different instruments will be resolved on the basis of the current Part XIC hierarchy).

- The access provider can offer to provide the service on terms that are different to the Standard Offer, but the Standard Offer must be available.

- Where an access provider and an access seeker enter into an access agreement that is the same as the Standard Offer, this is known as a Standard Access Agreement.

- Where the ACCC accepts a special access undertaking[12] or makes any new regulated terms (**the New Instruments**) in relation to the service, the access provider must:

    - update the Standard Offer so as to be consistent with the New Instruments (**the Updated Standard Offer**); and

    - vary each Standard Access Agreement in accordance with the New Instrument unless both parties agree in writing that the agreement should not be varied (this includes giving effect to any retrospective operation of any of these instruments[13]). Any such agreement would result in a non standard access agreement that would sit at the top of the Part XIC hierarchy.

This would result in a new Part XIC hierarchy as follows:

[11] Framing Paper Submission section 6.4.

[12] A special undertaking in respect of an existing declared service is only possible in the case of an NBN Corporation where the service is declared by virtue of section 152AL(8D) and 152AL(8E) of the CCA and no access determination has been made in relation to the service - see section 152CBA(1) of the CCA.

[13] The ACCC has the power to back date a final access determination to act as a retrospective replacement for an interim access determination - see section 152BCF(4A).

Non Standard Access Agreement
Special Access Undertaking
Binding Rules of Conduct
Access Determination
Standard Access Agreement

These refinements have the following advantages:

- Where the parties agree on terms and conditions of access and wish to have those terms and conditions of access locked in, the parties can enter into a Non Standard Access Agreement.

- Where the parties cannot agree, the default terms will be the Standard Access Agreement (there will therefore be no uncertainty as to what the terms of access are). The parties would then be free to seek regulatory intervention which could override the terms of the Standard Access Agreement.

- The ACCC would not be required to make access terms which 'cover the field' but could instead focus its attention on dealing with the issues that access seekers and access providers have not been able to reach agreement on.

- Regulated terms could apply to multiple access seekers without the need for each access seeker to enter into an arbitration.

As regards the SFAA, iiNet submits that the SFAA can play the role of NBN Co's 'Standard Offer' which, if accepted, becomes a Standard Access Agreement.

10. STANDARD ACCESS OBLIGATIONS

iiNet notes the following statement in the Consultation Paper:[14]

> *However, it is arguable that the SAOs do not ensure that services are supplied in an equivalent manner. This is implicitly recognised by the inclusion of interim equivalence and transparency arrangements in Telstra's structural separation undertaking. These arrangements were required to provide for greater levels of equivalence in how the services are supplied by Telstra to access seekers, notwithstanding the fact that the services covered by the interim arrangements are also declared services.*

iiNet believes that there is force in this statement. iiNet submits that the SAOs can be improved by including additional overarching SAOs as follows:

[14] Consultation Paper, at p.11.

- Where an access provider is vertically integrated, the access provider is subject to an overarching SAO that requires the access provider to provide equivalence between the access provider's retail business and access seekers as regards the provision of declared services (**the Overarching Category A SAO**).

- When an access provider (i.e. any access provider not just NBN Co) is not vertically integrated, the access provider is subject to an overarching SAO that requires the access provider not to discriminate between access seekers (**the Overarching Category B SAO**).

Additional provisions to the following effect would be required to give practical efficacy to the Overarching Category A and Overarching Category B SAOs (**the Overarching SAOs**):

- the ACCC would have an obligation to have regard to achieving the Overarching SAOs when it makes a relevant regulatory decision (e.g. makes an access determination); and

- in order to provide certainty to access providers, access providers would be deemed to comply with the Overarching Category A SAO if they comply with any applicable regulated terms made by the ACCC.

As regards the Overarching Category B SAO, iiNet notes that the Panel has posed the following question in the Consultation Paper:

> *The panel is therefore seeking views on whether the non-discrimination provisions applying to NBN Co and superfast network operators should be retained, relaxed or repealed.*

iiNet has obtained the view of Frontier Economics to address the following question:

> *Whether the benefits of removing the prohibition of NBN Co discriminating between access seekers would outweigh the costs of removing that prohibition?*

The following is a high level overview of Frontier Economics' conclusions on this issue based on iiNet's understanding of the Frontier Economics Report.

Discrimination can lead to outcomes that will promote economic efficiency (**useful discrimination**). However, discrimination can also lead to outcomes that will harm competition where it is based not on efficiency but on negotiation power (**harmful discrimination**). Notwithstanding that NBN Co is not vertically integrated, NBN Co will have an incentive to engage in harmful discrimination in favour of an access seeker where NBN Co is reliant on obtaining, or gaining access to, infrastructure owned by the access seeker, or where it fears competitive upstream integration by that access seeker.

Therefore, in principle, the best approach to take would be to allow useful discrimination and prohibit harmful discrimination. However, experience has shown that, in practice, it may not be possible to easily distinguish between useful discrimination and harmful discrimination, and a regulatory regime that attempts to do so leads to high uncertainty and high regulatory and compliance costs. Therefore, the realistic choice appears to be between:

- prohibiting discrimination completely; or
- allowing it, subject to the general competition provisions in the CCA.

Each option has its advantages and disadvantages but, on balance, prohibiting discrimination completely is the best approach to take because it is the option that leads to the biggest net gain. The detailed reasons for this conclusion are set out in section 4 of the Frontier Economics Report.

11. ACCESS DETERMINATIONS

iiNet does not believe that any material changes need to be made as regards the provisions in Part XIC dealing with access determinations. iiNet submits that there are problems with the effectiveness of access determinations due to the Part XIC hierarchy. The problems with the Part XIC hierarchy and iiNet's proposed solution to those problems are discussed in section 6 of the Framing Paper Submission and in section 9 above.

12. BINDING RULES OF CONDUCT

The Consultation Paper raises the following two questions in relation to BROCs:

- whether the power to make binding rules of conduct (**BROCs**) should be removed, retained or expanded; and
- whether BROCs should be subject to merits review and/or procedural fairness.

As regards the first question, as identified in the Consultation Paper, BROCs were designed to allow the ACCC to deal with urgent problems relating to the supply of declared services without the delays necessarily caused by normal consultation requirements. Examples of the types of problems that BROCs are intended to address are competition issues which require speedy regulatory action such as inadequate exchange access processes or inadequate service migration processes.[15]

[15] See Telecommunications Legislation Amendment (Competition and Consumer Safeguards) Bill 2010 Explanatory Memorandum, at p.50.

As a matter of principle, iiNet can see definite utility in the regulator being able to take speedy action to address obvious problems, such as the examples given able. As a matter of principle, the old adage '*justice delayed means justice denied*' justifies the existence of the power to make BROCs. However, iiNet submits that the practical effectiveness or otherwise of the power to make BROCs needs to be considered in the context of the problems with the legislative hierarchy discussed in section 6 of the Framing Paper Submission. iiNet submits that the power to make BROCs should be retained. However, changes need to be made to the legislative hierarchy to ensure that BROCs are not overridden by the terms of an access agreement that has resulted from an exercise of superior bargaining power by the access provider. These changes are discussed in section 6 of the Framing Paper Submission and in section 9 above.

iiNet notes that the Consultation Paper refers to the fact that the power to make BROCs has never been used by the ACCC. iiNet submits that this does not justify removing the power, because although it has not been formally used, there is evidence that the existence of the power to make BROCs has had practical utility. For example, the existence of the power has been embraced by NBN Co as a way of allowing a speedy means of regulatory recourse in the context of disputed variations to the terms of access to NBN Co's satellite service.[16] Furthermore, the legislative hierarchy has the effect of limiting the utility of BROCs and this may also explain why they have not been used to date (i.e. if all access agreements override all BROCs, then the utility of BROCs is significantly reduced. However, if only genuine access agreements override BROCs, their utility is increased).

As regards whether BROCs should be subject to procedural fairness and/or merits review, iiNet submits that the nature of the power means that for BROCs to be effective, the ACCC must be able to take speedy action so procedural fairness is not appropriate. As regards merits review, the fact that BROCs can only remain in force for a maximum of 12 months mitigates any damage that may be caused by 'regulatory error' on the part of the ACCC (i.e. the intention being that BROCs will be short term only and will be, if necessary, replaced by the terms of an access determination which will be subject to a requirement to hold a full public inquiry). Therefore, in iiNet's opinion, merits review is not necessary.

13. SPECIAL ACCESS UNDERTAKINGS

iiNet does not have any firm views on the utility or otherwise of special access undertakings except to note that some rationalization of the criteria for acceptance may be desirable because different acceptance criteria apply to the terms in the special access undertaking relating to:[17]

[16] See clause F4.2 Satellite Wholesale Broadband Agreement 12 February 2014 http://www.nbnco.com.au/industry/service-providers/agreements/satellite-wba.html

[17] See section 152CBD of the CCA.

- compliance with the SAOs - the ACCC must not accept the undertaking unless the terms are consistent with the SAOs and any applicable ministerial pricing determination and the terms are reasonable; and

- 'specified conduct' - the ACCC must not accept the undertaking unless the conduct will promote the LTIE.

In practice it may not always be easy to clearly distinguish between terms that relate to compliance with the SAOs and terms that relate to 'specified conduct'.

14. MINISTERIAL PRICING DETERMINATIONS

iiNet does not have any firm views on the utility or otherwise of Ministerial Pricing determinations. However, iiNet notes the view expressed in the Consultation Paper that Governments have been reluctant to directly involve themselves in the detailed administration of the access regime.

15. ACCESS AGREEMENTS AND HIERARCHY OF TERMS

iiNet notes that the Consultation Paper identifies the main question arising from this issue as whether access agreements should continue to have primarcy in the regulatory framework. iiNet submits that it is not necessary to change the order of the Part XIC hierarchy. What is required is to have a more refined approach to access agreements and create a mechanism that promotes an outcome where the access agreements that sit at the top of the hierarchy are genuine agreements that are not the result of an exercise of unequal bargaining power by an access provider. How this can be achieved is explained in section 6 of the Framing Paper Submission and also in section 9 above.

16. SUPPLY OF ELIGIBLE SERVICES BY NBN CO TO BE ON A WHOLESALE-ONLY BASIS

This issue was addressed in section 5.3.2 of the Framing Paper Submission. The wholesale only requirement is currently effected by NBN Co being permitted to supply services only to carriers or carriage service providers (subject to a number of limited exceptions that relate to transport and utility bodies).[18] To become a carrier all that is required is that a carrier licence be obtained. iiNet believes that obtaining a carrier licence is a relatively straightforward matter that is unlikely to be an effective barrier to a large corporate entity that is looking to save costs on its telecommunications services by obtaining services directly from NBN Co. There are no licensing requirements to become a carriage service provider. In light of this, iiNet believes that the wholesale only requirement should be tightened so that (subject to the current exceptions that apply to transport and utility bodies) NBN Co be restricted from selling services except to a carrier or carriage

[18] *National Broadband Network Companies Act 2011*, section 9.

service provider on condition that the carrier or carriage service provider does not supply NBN services to end users within its immediate circle[19].

17. NBN CO'S ABILITY TO SUPPLY TO UTILITIES

iiNet has no firm views on this issue.

18. NBN CO ABILITY TO DEAL WITH END-USERS

The consultation paper raises the question:

> *whether there are circumstances in which NBN Co may be perceived as needing to deal directly with end-users and, if so, the rules that would apply where it was permitted to do so.*

iiNet assumes that by 'deal directly with end users' the Panel is considering a situation where NBN Co is permitted to supply services to end users. iiNet is strongly against this outcome. One of the central rationales for the creation of the NBN was to address the problem of Telstra's vertical integration. iiNet believes there is no benefit to be gained, and considerable risks arising, from allowing NBN Co to become vertically integrated even if it is in only in very limited circumstances.

19. RESTRICTING NBN CO TO THE SUPPLY OF LAYER 2 SERVICES

iiNet believes that it is appropriate that NBN Co not be allowed to provide services any higher than layer 2. In addition to this, iiNet believes that service consideration should be given to requiring NBN Co to provide access at Layer 1. iiNet believes that not having access to Layer 1 is a serious impediment to innovation because access seekers are reliant on NBN Co and its convoluted product development forum processes to implement innovative ideas. iiNet believes that access to Layer 1 opens up an extra dimension of competition at the retail level. For example, the innovative 'naked DSL'[20] product would not have been possible without Layer 1 access to Telstra's copper network and it is likely that without the 'naked DSL' service, retail customers would not be able to obtain a broadband internet service using Telstra's copper network without also being forced to obtain a PSTN voice service.

[19] As defined in section 23 of the Telecommunications Act 1997 (subject to sensible carve outs for employees and the like).

[20] A 'naked DSL' service provides a broadband internet service over the copper customer access network without a PSTN voice service.

20. SUPPLY OF OTHER GOODS AND SERVICES

iiNet has no firm views on this issue.

21. RESTRICTIONS ON INVESTMENT ACTIVITIES

iiNet has no firm views on this issue.

iiNet Limited
14 April 2014

If the Panel requires any further information from iiNet, please contact Steve Dalby, iiNet's Chief Regulatory Officer
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The future of the telecommunications access regime

A REPORT PREPARED FOR IINET

April 2014

The future of the telecommunications access regime

The future of the telecommunications access regime

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Executive summary

The Government's review of the regulatory framework set out in Part XIC of the Competition and Consumer Act (the Act) and associated review of regulations affecting the structure and behaviour of NBN Co are a timely opportunity to consider the successes of the current regime and the potential for improvements.

The Expert Panel's consultation paper raises a large number of questions about the current regime; our submission addresses a small but important sub-set of the questions asked by the Expert Panel:

- Is the legislative objective of Part XIC the right one?
- Is there evidence from the current regime that would support a different legislative approach to access pricing that would facilitate more efficient investment?
- Should NBN Co remain subject to price discrimination prohibitions?

Our analysis and findings are summarised as follows.

Legislative objectives

The current LTIE test provides a balanced and flexible approach to regulatory decision making under the Act. While it emphasises the importance to the regulator of encouraging efficient investment, it does not prioritise the achievement of this objective over other objectives such as the promotion of competition. The benefits of this approach are clear in those cases where external factors (such as retail price controls) have meant no decision was available to the ACCC that would meet all the sub-criteria set out in s.152AB(2) of the Act (e.g. those cases where decisions involved a trade-off between encouraging efficient use of and investment in infrastructure on the one hand, and promoting competition on the other). In these circumstances, the broader LTIE test enables a decision maker to weigh the differing effects of the decision on key criteria so as to determine which decision would best promote the long-term interests of end-users overall. It cannot and should not be assumed that encouraging efficient investment will always lead to an outcome that is in the best interests of society, or best promotes the LTIE.

In fact, our view is that the expression of objectives in the Part XIC regime is superior to how objectives are expressed in the Part IIIA national access regime. The Part IIIA regime appears to place competition objectives above those of efficiency. That is, it seeks only to promote efficiency where it is likely to promote competition in downstream or upstream markets. We believe the over-riding objective of Part IIIA is inferior to the LTIE test because there may be socially beneficial decisions that promote the efficient use of or investment in infrastructure even where they don't promote competition. The LTIE test allows

a balancing of relevant considerations where such conflicts may occur so that better decisions can be made by regulatory decision-makers.

Access pricing

A concern raised by some at various times over the last 17 years in which the telecommunications access regime has been in place is that the ACCC has discouraged efficient investment by allowing below-cost access prices. These issues again appear to have been raised in this review, and the Panel asks whether a better approach might be to set out pricing approaches in legislation. It is not obvious to us that the Panel has identified a particular problem with the current approach to access pricing across the different services that the ACCC regulates. The LTIE sub-criteria in s.152AB(2) of the Act already require the ACCC to take account of efficient investment, and the broader criteria relating to matters the ACCC must have regard to in s.152AH of the Act when making a final access determination (FAD) on prices for declared services include consideration of the legitimate business interests of access providers.

The ACCC has taken different approaches to access pricing both over time and by service type. This merely reflects that access pricing is not a 'one size fits all' approach. We discuss examples of how the ACCC has needed to change approach and use different approaches, and how the New Zealand approach which locks pricing principles into legislation can reduce regulatory efficiency.

We also discuss the notion that the ACCC's recent changes in the pricing of fixed line services have reduced Telstra's returns and do not support future investment. We find these claims are inaccurate and inconsistent with (favourable) market reactions to Telstra's share price since the ACCC changed its approach. In summary, we have not observed any compelling evidence that:

a. the regime creates a serious risk of access prices being set below efficient costs

b. even if there was such a risk, that this could be readily fixed by reducing the regulator's discretion by using Ministerial pricing determinations or using fixed provisions in legislation.

Price discrimination

NBN Co is currently limited from discriminating between access seekers, and must offer services on an open access and equivalent basis. Although there are some exceptions to this, they are minor, and most importantly, there is no ability to offer discriminatory terms to access seekers where this could promote efficiency.

The Panel's questions focus on whether, in light of NBN Co's vertical separation, the price discrimination provisions are necessary and proportionate.

We agree with the Panel that there are few circumstances in which NBN Co would seek to discriminate in favour of particular access seekers to the detriment of competition. However, arguably, such circumstances do exist here as NBN Co is reliant on other infrastructure owners for access to infrastructure, and because it may fear upstream vertical integration by infrastructure owners. In these circumstances, NBN Co's incentives in improving its commercial position may jeopardise its normal incentives to promote competition in the downstream market.

This analysis suggests that the terms of any deals struck between NBN Co, Telstra and Optus about infrastructure sharing or competition are important. In this regard, we note that while the currently-prevailing deals may limit NBN Co's incentives to discriminate, these deals are currently subject to renegotiation. The absence of price discrimination controls would raise the possibility that the existing terms struck could be altered in ways that favour the infrastructure owners.

If we can establish that there are some circumstances in which discrimination might prove anti-competitive, the choice of regulatory approach to deal with these concerns is difficult. Approaches that facilitate discretion for the regulator to assess the efficiency of particular deals are unappealing, given past experience, and relying on Part XIB or Part IV of the CCA would probably be tantamount to allowing discrimination in most circumstances. We suggest that the current provisions should stay, with the possible addition of a reasonable time limitation at which point the provisions would be reviewed or would fall away.

1 Introduction

1.1 Background

On 12 December 2013, the Federal Government announced the terms of reference for the Cost-Benefit Analysis and Review of Regulation of NBN. This review is being undertaken by a Panel of Experts (the 'Vertigan review') and is broad-ranging. Its purpose is to:

> analyse the economic and social costs and benefits (including both direct and indirect effects) arising from the availability of broadband of differing properties via various technologies, and to make recommendations on the role of Government support and a number of other longer- term industry matters.

Under its term of reference, the panel is required to undertake a statutory review of the telecommunications industry access arrangements under section 152EOA of the *Competition and Consumer Act 2010*. The paper also provides an overview of provisions in the *National Broadband Network Companies Act 2011* that need to be reviewed, and raises questions about its operation.

On 24 March 2014, the NBN Panel of Experts released a consultation paper seeking views from industry and the public on the telecommunications industry access arrangements. It provides an overview of the Part XIC access regime and raises issues and questions in relation to its principles and operation. It also presents some possible high level alternative approaches. Similarly, the paper provides an overview of provisions in the *National Broadband Network Companies Act 2011* (the NBN Companies Act) that need to be reviewed, and raises questions about their operation.

1.2 Instructions

Frontier Economics (Frontier) has been engaged by iiNet to provide our expert opinion on a number of matters raised in the current review of the NBN and the telecommunications access arrangements.

Frontier's consultants have been involved in the implementation of the access arrangements since their beginning in 1997. Over the years, we have provided advice to access seekers, access providers, the ACCC and policy makers on access arrangements. Our consultants are also familiar with telecommunications access regimes in Europe and in New Zealand.

Our instructions are to provide an expert opinion for the Panel's consideration on the following matters:

- The benefits of a statutory test based on promoting the long term interests of end users as opposed to a statutory test that is based on promoting investment.

- Whether the ACCC's approach to pricing declared services under Part XIC of the Competition and Consumer Act has resulted in access prices that are below cost and which are a disincentive to investment.
- Whether the benefits of removing the prohibition on NBN Co discriminating against access seekers would outweigh the costs of removing that prohibition.

In the remainder of this submission, we address these questions, drawing where possible on both economic theory and our experiences at a practical level in dealing with the Part XIC regime and broader *Competition and Consumer Act 2010* matters.

2 The objectives of Part XIC

2.1 The LTIE test

Section 152AB(1) of the Act sets out the over-riding objective of Part XIC of the Act, and states that:

> The object of this Part is to promote the long-term interests of end-users of carriage services or of services provided by means of carriage services.

Section 152AB(2) provides further elaboration, and states that:

> For the purposes of this Part, in determining whether a particular thing promotes the long-term interests of end-users of either of the following services (the **listed services**):
>
> (a) carriage services;
>
> (b) services provided by means of carriage services;
>
> regard must be had to the extent to which the thing is likely to result in the achievement of the following objectives:
>
> (c) the objective of promoting competition in markets for listed services;
>
> (d) the objective of achieving any-to-any connectivity in relation to carriage services that involve communication between end-users;
>
> (e) the objective of encouraging the economically efficient use of, and the economically efficient investment in:
>
> i. the infrastructure by which listed services are supplied; and
>
> ii. any other infrastructure by which listed services are, or are likely to become, capable of being supplied.

Importantly, the legislative regime does not presume that any one of the three sub-criteria set out in section 152AB(2) should be given priority over the others. That is, encouraging the economically efficient use of, and investment in, infrastructure is not presumed to carry more or less weight than the objective of promoting competition when considering whether a particular thing promotes the LTIE.

Further elaboration on the matters a decision maker must have regard to are set in further sub-sections of s.152AB, which also place a strong emphasis on:

- the legitimate commercial interests of the supplier or suppliers of the services, including the ability of the supplier or suppliers to exploit economies of scale and scope (s152AB(6)(b))
- the incentives for investment in the infrastructure by which the services are supplied; and any other infrastructure by which the services are, or are likely to become, capable of being supplied (s152AB(6)(c))

- Investment risks, to which regard must be had when interpreting incentives for investment (s152AB(7)).

2.2 The Panel's questions

The Panel asks submitters a broad range of questions about the future objectives of Part XIC and whether the LTIE test should continue in its central role:

> The LTIE test is central to the declaration process but also the wider operation of Part XIC and, as such, the panel is particularly interested in views on how it is currently operating or how it could be revised. As noted above, it has been largely unchanged since 1997. The criteria reflect circumstances at that time, including the telecommunications market structure, and it is worth considering whether these are still the matters of greatest importance in deciding whether actions are in the LTIE (as broadly understood).
>
> In summary, the panel is seeking views on whether the LTIE test needs to be revised and, if so, to what end. Should greater emphasis be given to the promotion of investment and, if so, how? Should different categories of investment be given greater weight, e.g. investment in networks, infrastructure required to interconnect with networks (e.g. DSLAMs) or services? Is any-to-any connectivity still relevant? Is guidance required on the definition of a market? Should the LTIE criteria be brought closer in content and operation to those set out under the National Access Regime, and if so, how? The panel is also interested in views about the application of the LTIE test throughout Part XIC.

For reasons that we shall now explain, we are supportive of the central role of the LTIE test, and with its current framing.

2.3 The LTIE test is more balanced and flexible than a test that focuses on promoting investment

The primary objective of Part XIC of the Act is the promotion of the LTIE of telecommunications services. In this regard, end-users are the final consumers of telecommunications services – that is, those who acquire and consume them.

In considering whether a particular thing (e.g. a decision regarding whether to regulate a service; or the price of a regulated service etc.) is likely to promote the LTIE, the Act also requires a decision maker (such as the ACCC) to have regard to the three "sub-criteria" in section 152AB(2) of the Act.

It follows, therefore, that the LTIE is the over-arching objective; and the sub-criteria are different factors that may be relevant considerations in determining whether something is likely to be in the LTIE. In other words, the sub-criteria are factors that may impact on the LTIE. Importantly, regard must be had to them when considering whether a thing is likely to promote the LTIE. This legislative framing has a number of important implications which we consider in turn below.

2.3.1 The LTIE test requires consideration of investment incentives

At the outset, it is important to note that the LTIE test already requires a decision maker to have regard to whether a decision will encourage economically efficient investment. This is because the decision-maker must have regard to whether a thing would, *inter alia*, be likely to encourage efficient investment when deciding whether it would be in the LTIE.

Importantly, this suggests that promoting the long-term interests of end-users is not, as a general rule, viewed as being in conflict with encouraging efficient investment under the LTIE test. Instead, encouraging efficient investment is seen as an important factor that can contribute toward promoting the LTIE.

Ultimately, end-users will not benefit if, over time, there is little or no investment in the infrastructure used to provide telecommunications services. The LTIE test recognises this. To the extent that encouraging efficient investment is considered an important objective of a telecommunications access regime, it should be recognised that the existing regime – and the LTIE test – already requires a decision maker to have regard to it.

2.3.2 Greater investment *per se* may be harmful to social welfare

While it is important both for consumers, and social welfare more broadly, that investments in infrastructure are made over time, it is not the case that *any* investment is in the best interests of society as a whole. At a conceptual level, this is not difficult to understand. For instance, it would be wasteful to invest in infrastructure (such as a bridge) if such infrastructure provided benefits less than the cost of building it. It is for this reason that many infrastructure projects are subject to a cost-benefit analysis – to see whether there are benefits from the project that outweigh the costs of doing it. A test that focuses only on promoting investment is unlikely to be sensible because it is likely to encourage investment in infrastructure that may be economically inefficient and not provide benefits greater than the cost of the investment.

The same principle applies in the context of investment used to build infrastructure necessary to provide telecommunications services. For instance, it may be socially wasteful to build a fibre-to-the-home (FTTH) network to all premises in Australia if services that could be provided on that network were not valued as highly as the cost of building and operating the network. Indeed, if promoting investment were the primary objective that should drive all policy and regulatory decisions in telecommunications, one may erroneously conclude that building the most extensive FTTH network reaching all homes in Australia was consistent with this objective.

Relatedly, pricing principles that rewarded investors without regard to the efficiency of investment would lead to socially undesirable outcomes. This is recognised in the economic literature:

- Setting access prices based entirely on the basis of actual/historic costs incurred by the access provider gives it little incentive to pursue productive efficiencies and facilitates 'gold plating'.
- Fixing a rate of return on whatever capital costs are incurred can provide an incentive for regulated firms to inefficiently over-invest in capital relative to other factors of production that could be used to provide its services. This is sometimes referred to in the literature as the 'Averch-Johnson' effect.[1]

If the focus of Part XIC was solely to promote investment irrespective of whether this investment was efficient or not, however, then a decision-maker could conclude that an appropriate pricing principle would be one that allows an access provider to set prices aimed at recovering whatever investment costs it incurs, plus some level of return on this investment. Such an approach would promote investment because it would guarantee investors a return on their investment. Clearly, however, it would encourage inefficient investment that would not be in the best interests of society as a whole.

In our view, therefore, the promotion of greater investment *per se* is not an appropriate objective in itself. To the extent that promotion of investment is seen as an important objective, the focus needs to clearly be on promoting *efficient* investment. This is defined as investment that creates more benefit to society than the cost of that investment.

2.3.3 Efficient investment may not always deliver outcomes that are in the best interests of society

In most cases, something that promotes efficient investment is likely to be consistent with the promotion of other important objectives. For instance, an access price that promotes competition in telecommunications markets is also likely to encourage the efficient use of, and investment in, telecommunications infrastructure. This is because competitive markets will, in general, deliver outcomes consistent with economic efficiency. Such a view has been recognised by the Australian Competition Tribunal, where it found that:

> Competition is a process, not a situation: *Re Queensland Co-Operative Milling Association and Defiance Holdings* (1976) 8 ALR 481 at 514-515. It is the way in which firms interact, and respond to each other, to ensure they best achieve their individual objectives. Under traditional economic theories of the firm, firms are

1 See Averch, H and Johnson, L., (1962) "Behaviour of the Firm Under Regulatory Constraint", *American Economic Review*, 52(5): 1052-1069.

usually considered to operate with the objective of maximising profits. In general it is assumed that firms with this objective will compete to win market share from each other. In turn, competition between firms in this way is desirable from a consumer perspective because it creates incentives for firms:

- to lower their prices towards their costs of production in order to attract more consumers to their business so that they can expand their market share; and
- to seek greater productive efficiencies (now and over time) so that they may lower their costs of production. In turn, this enables them profitably to lower prices for consumers in ways that will attract more consumers to their business in order to increase their share of market. [2]

Similarly, in competitive markets, we should expect firms to pursue investments that enable them to gain a competitive advantage over their rivals. They can do this by making investments that enable them to provide the same services as their rivals at lower costs; or by investing to provide new services that provide value to consumers greater than the costs of providing these services.

It follows, therefore, that in many cases the sub-criteria set out in s.152AB(2) of the Act are complementary.

It is also possible, however, that a particular decision may have conflicting impacts on the achievement of different sub-criteria in s.152AB(2) of the Act. For instance, it may be the case that encouraging efficient investment is inconsistent with promoting competition in a market. This can be the case, for instance, where the government chooses to pursue an equity objective through the development of a retail price control. An example of such a situation arose when the ACCC sought to develop pricing principles for the local carriage service (see Box 1 below).

Box 1: The pricing of local carriage services

During the early part of the last decade, the ACCC declared a local call resale service (referred to as the local carriage service or LCS). When it came to determine an appropriate pricing principle for this service, an important factor was that the retail price Telstra was able to charge for local calls was capped at 22 cents per call. In submissions made to the ACCC, Telstra claimed this retail price control had the effect of forcing it to set retail prices for local calls at a level below the average cost it incurred to provide them. Accordingly, it was possible that a cost-based access price for a wholesale LCS could, on average, be greater than the capped retail price charged by Telstra for the service.

The fact that the average cost may have been above the capped retail price created a dilemma when it came to determining a pricing principle for the service. While a cost-based access pricing principle (such as total service long-run incremental cost (TSLRIC)) would likely have encouraged the economically efficient use of, and investment in, the infrastructure used to provide the LCS, it may have inhibited the ability of access seekers to compete to provide local calls to consumers using the LCS. Conversely, an alternative pricing principle such as deducting Telstra's retail costs from its retail price may have had the effect of enabling access seekers to compete to provide the service, but also had the effect of discouraging economically

2 Australian Competition Tribunal, *Telstra Corporation Lts (No. 3)* [2007] ACompT 3 at para [97] – [99].

efficient use of, and investment in, the infrastructure used to provide telecommunications services.

It is possible that reasonable minds might differ in their view regarding whether the ACCC made the right decision to adopt a 'retail minus' pricing approach for the LCS, which better promoted competition between Telstra and access seekers than alternative approaches. Any such concerns with the decision made by the ACCC would, however, in our view not reflect a problem with the underlying LTIE test – it would instead reflect a difference in opinion with regard to how the ACCC had applied the test. In our view, the LTIE test was helpful in demonstrating the trade-offs that were involved in making this decision, and in highlighting the potential distortions created by inconsistent retail and wholesale price controls.

Source: Frontier

Such examples have two clear implications. First, it can be the case that a regulatory decision that would promote economically efficient investment may also limit the promotion of competition in a telecommunications market (and vice-versa).

Second, where such a trade-off between different objectives exists, it should not be assumed that encouraging efficient investment will always lead to an outcome that best promotes the welfare of consumers, or society as a whole.

In our view, it is better to have an over-riding objective that enables a decision-maker to weigh these potentially conflicting effects. We believe a broader welfare test – such as the LTIE test – provides a mechanism for this to occur. As demonstrated in box 1, it allows a decision-maker to make a decision where the positive benefits from promoting one objective outweigh the negative detriment caused by negative consequences for another. Importantly, such a test does not preclude the making of decisions where the benefit derived from encouraging efficient investment outweighs the detriment caused by a lessening of competition in a market.

In contrast, setting an objective of promoting investment is overly narrow and risks locking the regulator into making decisions that, while promoting investment, may be contrary to the best interests of society at large. Further, a narrow test like promoting efficient investment risks focusing too much on one path to a suitable objective rather than the achievement of the objective itself. That is, encouraging efficient investment is only one factor that might help achieve benefits for society as a whole. Other factors, however, are also important. A broader test – such as the LTIE test – enables a full consideration of all relevant factors to occur.

2.3.4 Different categories of investment should not be given different weights

Value is created in economic terms when consumers are willing to pay for goods or services more than the cost of providing them. In our view, it does not matter what telecommunications services provide this value to society. A dollar of value

created by the provision of a service over a mobile network is just as important for overall social welfare as a dollar of value provided over a fixed line network. In that sense, the measure of economic efficiency that should be applied to considering investments in one form of telecommunications infrastructure is the same as the measure of efficiency that should be applied to all forms of investment in telecommunications infrastructure.

While it may be there are reasons to justify governments subsidising investment by operators in particular forms of telecommunications infrastructure[3], these considerations should not be determinative of whether a particular service provided over that infrastructure should be the subject of regulation (i.e. declared).

Instead, we believe that services provided over all forms of telecommunications infrastructure should be subject to the same (LTIE) test when considering whether they should be declared.

2.4 Is any-to-any connectivity still relevant?

In our experience, the objective of achieving any-to-any connectivity has been influential in few, if any, decisions made by the ACCC or the Tribunal under Part XIC of the Act. In most decisions made by the ACCC that we have considered, the any-to-any connectivity criterion appears to receive only passing consideration.

One exception to this was the ACCC's decision to continue declaration of a mobile terminating access service (MTAS) in June 2004. In that decision, the ACCC provided some analysis setting out how declaration (and reasonable pricing) of the service could ensure larger mobile operators were unable to inhibit the ability of smaller competitors to effectively compete in the market by refusing to interconnect with them. Such a refusal (or a move by existing operators to set access prices for a new entrant at excessively high levels) could have had the effect of preventing consumers on the smaller network from making calls to (and receiving calls from) consumers on the larger networks.

In our view, the any-to-any connectivity criterion is a relic of a time when the regime was first introduced. At that time, Telstra was the largest provider of telecommunications services in Australia. Ensuring consumers on all networks were able to communicate with each other was an important factor in ensuring the development of competition in these markets. Providing a strong legislative signal that the Government would require interconnection between networks –

3 For instance, it may be there are positive externalities created by the provision of goods and services over some forms of infrastructure that would not be captured if the market was left to determine whether the service should be provided.

and hence any-to-any connectivity – provided certainty to new entrants that they would be able compete in the market.

It is still possible today that a new entrant may be inhibited in its ability to enter a market if it is unable to interconnect with existing network operators. For instance, if a new entrant sought to build and provide services over a new mobile network, existing operators could inhibit its ability to compete if they refused to interconnect with it. Such actions would prevent any-to-any connectivity, and prevent competition developing in the market.

For this reason, we believe it is important to continue to consider whether regulatory decisions will help achieve any-to-any connectivity. It is possible, however, that these concerns could still be met if they were considered within a criterion focusing on whether a regulatory decision would promote competition in a market for a listed service.

As it stands, we believe the any-to-any criterion does little harm. However, it may be that a specific sub-criterion relating to this objective is not necessary as the concerns it seeks to address could be met under the sub-criterion relating to the promotion of competition.

2.5 Should the LTIE criteria be brought closer to the criteria set out in Part IIIA?

Section 44AA of the Act sets out the objective of Part IIIA of the Act, and states that:

> The objects of this Part are to:
>
> (a) promote the economically efficient operation of, use of and investment in the infrastructure by which services are provided, thereby promoting effective competition in upstream and downstream markets; and
>
> (b) provide a framework and guiding principles to encourage a consistent approach to access regulation in each industry.

Unlike Part XIC of the Act, Part IIIA places the initial focus of the national access regime on promoting the economically efficient operation of, use of and investment in the infrastructure by which services are provided. However, this is done because the object assumes this will promote effective competition in upstream and downstream markets. In that sense, therefore, Part IIIA sees the promotion of competition in upstream and downstream markets as the over-riding goal of Part IIIA.

In our view, there are two concerns with adopting this objective as the fundamental objective underpinning Part XIC of the Act. First, we are not convinced that the promotion of competition in related markets *per se* should be

the end in itself of the telecommunications access regime. Competition should be promoted only where it will increase the welfare of society as a whole. Just as it is possible that something that encourages efficient investment may not promote competition in a way that, on balance, is harmful to the welfare of society as a whole, it is also possible that a decision that promotes competition to only a small extent may not be welfare enhancing if it leads to incentives for substantial inefficient investment.

We continue to believe the LTIE test provides a balanced and flexible over-riding objective that should be retained as the primary purpose of Part XIC of the Act.

3 Does the ACCC's approach to access pricing result in prices below cost?

3.1 Approaches to access pricing under Part XIC

Part XIC of the Act gives the ACCC flexibility in the choice of access pricing method to apply once it has declared a service.

The ACCC has adopted a wide range of pricing methods historically, and continues to do so for currently declared services. For example, at present:

- **Fixed line services**: A building block model using a locked in regulatory asset base (a form of average cost pricing, with incentive mechanisms).
- **Mobile termination services**: an estimate of the TSLRIC of supplying the service, based on a forward looking optimised costs.
- **Transmission capacity**: prices for non-competitive routes are benchmarked against competitive routes using econometric methods.

In earlier periods, the ACCC has also applied other methods, including:

- 'retail minus' pricing, where access prices are based on the retail price, less the retail costs incurred by Telstra (applied to local call resale or LCS services – see box 1 above).
- Benchmarking against Telstra's prices (applied to PSTN network services supplied by non-dominant firms)

The ACCC has also amended its methods, in certain instances, to reflect peculiarities associated with retail price controls. This included, for example, the inclusion of an 'access deficit contribution' included in PSTN access prices due to constraints applying to the pricing of retail line rental services; and decisions regarding whether prices for the unconditioned local loop service (ULLS) should be geographically averaged or not.

3.2 The Panel's questions

The Panel asks a range of questions of submitters on the pricing of declared services, noting in particular that Part XIC is silent on the methodology to be employed by the ACCC in setting access price terms and conditions. The Panel notes that:

> Specifying particular methodologies to be used in Part XIC could enhance the predictability of regulatory outcomes but might affect the ACCC's ability to respond flexibly to changing circumstances or take a more nuanced approach where that would be desirable. For instance, a test could be introduced requiring the ACCC to be satisfied that any access determination will allow recovery, at least in expectation,

> of prudently incurred costs. That could promote investment, but would leave open the precise methodology by which that likelihood of cost recovery had been assessed.

The Panel then asks:

> More specifically, should the methodology for determining wholesale prices be specified in legislation? If so, should this be at a high level (e.g. cost based approach) or a more detailed level (e.g. building block methodology)? Should use of the Ministerial pricing determination (see below) to provide guidance to the ACCC be encouraged? Should specific guidance be provided to the ACCC, for example, on how to take account of embedded cost subsidies when determining prices? Should the ACCC consider non-price factors such as positive and negative externalities?

The Panel's questions here appear to reflect a view that there are deficiencies with the current pricing approaches adopted by the ACCC, and in particular, that the ACCC's approach(es) have not allowed the recovery in expectation of prudently incurred costs.

It is not obvious to us that the Panel has identified a particular problem with the current approach to access pricing across the different services that the ACCC regulates. The LTIE sub-criteria in s.152AB(2) of the Act already require the ACCC to take account of efficient investment, and the broader criteria relating to FADs include consideration of the legitimate business interests of the access providers. This has been taken to mean the recovery of the costs of supply, including a normal return on invested capital.[4]

As we shall go on to discuss, the different approaches taken to access pricing reflect some different circumstances around each of the declarations that have been made, which means that access pricing is not a 'one size fits all' approach. Further, we have not observed any compelling evidence that:

c. the regime creates a serious risk of access prices being set below efficient costs

d. even if there was such a risk, that this could be readily fixed by reducing the regulator's discretion by using Ministerial pricing determinations or using fixed provisions in legislation.[5]

In the following two sections, we take up these themes with respect to the pricing of the declared fixed line services, and transmission capacity pricing.

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4 *Re Telstra Corporation ACompT 4*, 2 June 2006, Para 89.

5 We consider both of these approaches would be inferior to allowing review provisions to check the ACCC's power.

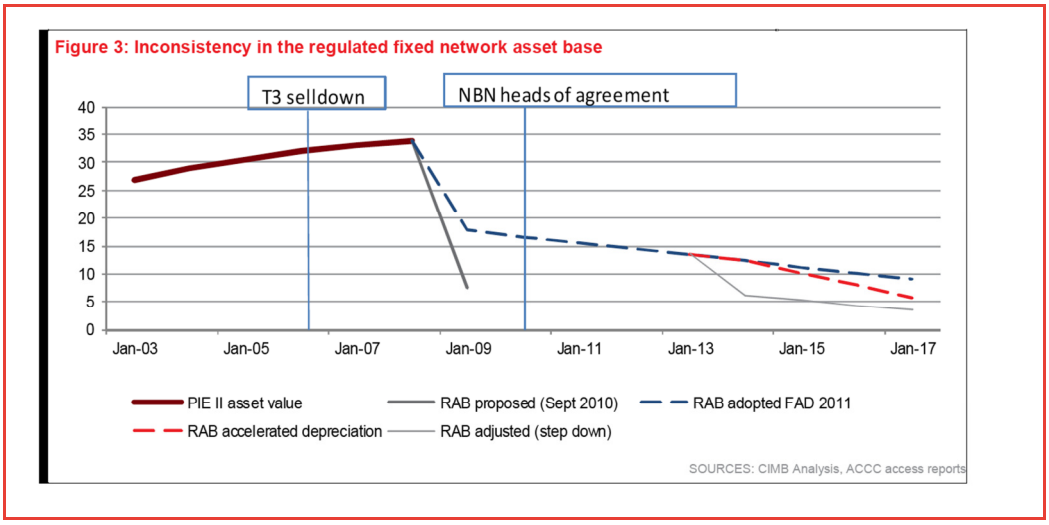
3.3 The ACCC's pricing of declared services allows for recovery of prudently-incurred costs

We note that there have been submissions to the Panel's earlier discussion paper (February 2014) which claim that the ACCC's approach to access pricing of the declared fixed line services (ULLS, WLR, LCS, PSTN OA and LSS) has not facilitated economically-efficient outcomes, and in particular has not achieved a 'capital efficiency' objective.[6]

This is argued to relate to the change made by the ACCC to its approach to estimating access prices for fixed line services during 2009-2011.

The key points made in this submission are made in the following diagram: that the ACCC proposed very large devaluations of the value of Telstra's network assets used to supply the fixed line services. The claim is made that over the period of the revised approach to pricing, the ACCC's 'backflips' cost Telstra shareholders, who "lost A$bns in valuation".

Figure 1: Has Telstra suffered from changes to the regulatory asset base?



Source: CIMB submission

This argument is then further developed to suggest that the objectives of the access regime should change:

> It is most fundamentally the comparison of value and cost that should drive such investments. In its regulation of the telecommunications sector the ACCC has removed any reference to demand driven valuations to the point where it bases regulated access prices for fixed line service on historic cost.

6 CIMB submission, available at http://www.communications.gov.au/broadband/national_broadband_network/cost-benefit_analysis_and_review_of_regulation/submissions_received

> These send the wrong signal to network investment and have discouraged efficient investment or any significant investment at all save that needed to continue a steady supply of service.[7]

These arguments incorrectly characterise the ACCC's actions in 2009, and also appears to be implying that Telstra would need to earn a return above its cost of capital to drive an efficient level of investment.

The so-called 'backflips' on access pricing approaches in 2009 reflect one fundamental change: from an unworkable 'TSLRIC' model that had long been the cause of contention between Telstra and the ACCC towards a building block model with a fixed regulatory asset base.[8]

Crucially, the change in methodology involved the move towards an approach that more closely reflected actual costs incurred by Telstra rather than the hypothetically derived costs that would be incurred by an efficient operator on a forward looking basis (TSLRIC). This involved a change from an *undepreciated* asset base (PIE II asset values in the diagram) to a *depreciated* asset base, so that the value of new investments could directly be recognised in the future regulatory asset base.

The notion that there was a significant fall in the asset base solely caused by the change from a TSLRIC method to a building block method – as shown in the graph – is simply false. Rather, the fall simply reflects that prior to 2009, Telstra's assets were valued as if they were new, while the post 2011 approach reflected that Telstra's asset base was already significantly depreciated (reflecting that the network assets were far from new).

To assess the impact of the change on Telstra and its shareholders, it is more relevant to observe the impact on *prices* of the different asset bases (which then determines the discounted value of the future income streams). The price impact depends not just on regulatory asset value but also on asset lives – over what period the asset value is depreciated. The ultimate effect of the change in asset base was that access prices essentially remained unchanged in the shift from the old regime to the new. Of further benefit to Telstra was that the asset base is now 'locked in', and not subject to the ongoing uncertainty of revaluation.

These changes do not sound like something that would dismay investors, or that the change in approach had stripped billions of dollars from Telstra's investors. This is in fact borne out in Telstra's share price, which showed a steady progression upwards from the middle of 2011 when the FAD was released, not a sharp decline.

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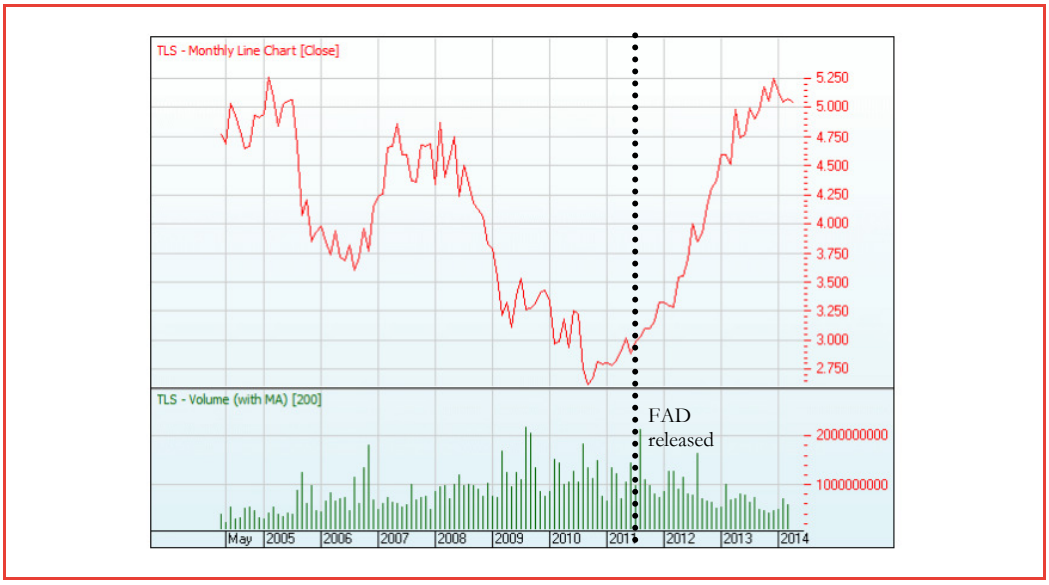
7 Ibid.

8 The background to this change is given in Warwick Davis, "From Futility to Utility: Recent Developments in Fixed line access pricing", *Telecommunications Journal of Australia*, 2011, Vol 61.

Figure 2: Telstra share price



Source: ASX.com.au

3.3.1 The ACCC's current approach to fixed line pricing provides the certainty investors prefer

A critical feature of any access regime is that investors need confidence that they can recover a normal commercial return that reflects the risk associated with investing in infrastructure assets.

The approach now used by the ACCC sets prices for regulated fixed line services using a building block model (BBM). This BBM, using a nominal WACC, allows for recovery of prudently made investments, plus a return on the capital invested.

The BBM provides considerable certainty to investors, particularly in its current form. It relies on Telstra's forecasts of costs and demands, and the ACCC applies prudency tests to forecasts. It is consistent with the approach adopted and refined in energy regulation over the past 15 years.

We also note that there is no external benchmarking of Telstra's network efficiency, and no adjustments to reflect any existing network inefficiencies. That is unlike methods in other jurisdictions like in the European Union, where 'bottom up' LRIC models are commonly used for fixed line services.

We would argue that the net effect is that the regulatory approach is relatively generous to Telstra.

It seems to be implicit in the arguments made about 'below cost' prices that the regulator should be setting prices on the basis of the cost of replacing the network, which would better reflect the 'economic value' of the assets. This was

debated extensively in 2009/10 at the time of the change in access pricing approach.[9]

While we do not wish to re-visit all of these arguments in this submission again, we emphasise the following points about the benefits of the new approach:

- Use of replacement cost asset valuations can have some benefits in particular circumstances:
  - Where there are issues with 'build or buy' incentives
  - Where investors have not been able to achieve a sufficient inflation-adjusted return on the acquisition cost of the assets due to unforeseen events
  - Where there are concerns about financing the costs of new investments
- None of these rationales are compelling in the current circumstances (of fixed line services in Australia)
  - Competing fixed-line customer access networks (and associated 'build or buy' decisions) are unlikely to emerge at any feasible level of access price
  - There is little evidence that investors have not earned reasonable returns on PSTN assets
  - There are no concerns about financing new investment; upgrades can be financed by borrowing against future cash flows.
- The use of replacement cost asset valuations significantly complicates the regulatory task of providing an investment condition of 'expected NPV = 0' that captures the concept of allowing a return on prudent investment. In particular, it requires complex adjustments to depreciation methods. Further, where assets are long-lived, use of replacement costs raises issues of optimisation of the network, which has in the past been costly and highly contentious. These replacement cost and optimisation approaches expose the regulated firm to unnecessary risk, as well as opening the potential for windfall gains or losses.
- For access pricing in telecoms in Australia currently, the use of a fixed RAB rolled forward periodically with forecasts of efficiently-incurred costs provides a better balance of incentives that alternative approaches that seek to reflect (optimised) replacement costs.

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9 Described in Davis, *op. cit.* See also ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services*, Draft report, September 2010, pp. 15-26.

3.4 Some discretion in the choice of pricing methodology is appropriate

In our view, the current regime that provides the ACCC with flexibility on the choice of pricing principles is appropriate. A regime that specifies a pricing methodology could reduce uncertainty about possible approaches that could be taken by the ACCC. But what would be lost is the ability to respond to changing circumstances, and in particular changes in the scope of competition, and service complexity.

There are two particularly good examples with which we are familiar that demonstrate the benefits of some flexibility in pricing approach: domestic transmission capacity services, and the access pricing principle approach in New Zealand.

3.4.1 Transmission capacity and benchmarking

Transmission capacity services are sometimes described as an essential building block for other kinds of communications services. The services are usually sold on a 'route by route' basis, or as 'tails' from a local exchange to a premise.

The challenge with these prices is that:

- Routes are priced route-by-route, but networks are usually designed with redundancy (or purchasers will purchase redundancy)
- Many routes, particularly larger routes where there are significant volumes of traffic, are competitively supplied with a number of infrastructure-based competitors

These factors create a significant problem if the regulator wants to regulate the price of only non-competitive routes.

- Modelling a single route understates the gains from economies of scope which can be derived from building an entire network that covers multiple routes. Redundancy is a key element of transmission network design.
- Allowing infrastructure suppliers to allocate costs across different routes encourages anti-competitive cost shifting from competitive to non-competitive routes. Conversely, excessive interventions in cost allocations can cause problems of cost under-recovery if insufficient allowances are made for recovery on non-competitive routes.

The particular solution that the ACCC has come up with is to benchmark non-competitive route prices with competitive route prices, suitably adjusted.

We would doubt that any access provider or access seeker – or even the ACCC – would pretend that this price method is simple or straightforward. However, if the ACCC was constrained to use a single method like a building block method,

the process would have been even more cumbersome and prone to controversy. It would require geographical breakdowns of asset costs – which do not currently exist – and require all access providers to prepare detailed regulatory accounting information at high cost to all involved. The controversy would invariably come from allocation of route common costs between competitive and non-competitive routes.[10]

3.4.2 Access pricing principles in New Zealand

The New Zealand telecommunications access regime provides a useful reference point for the Panel's consideration. The framework is broadly similar to Australia's, with similar objectives and coverage of declared services. However, one point of difference is that 'initial' and 'final' pricing principles are specified in legislation.

The relevant legislation (the New Zealand Telecommunications Act) requires the New Zealand Commerce Commission (NZCC) to use a two-step process to determine the forward-looking cost of a replacement network and set prices for services that are equivalent to our ULLS and wholesale ADSL services (called UCLL and UBA in New Zealand):

- Firstly, to set initial prices by benchmarking cost-based prices for similar services in comparable jurisdictions overseas.
- Secondly, if any party is unhappy with the initial pricing principle, they can ask the NZCC to move to issue a final pricing principle. This involves setting prices on the basis of long-run forward-looking costs, in effect the cost of replacing the network (TSLRIC)

This regime, which was established around 13 years ago, reflected best practice at that time and was broadly consistent with practices in Australia. However, as we have seen in Australia, it is no longer so obvious that these pricing principles have remained the appropriate ones. As a simple point of comparison, Australia now makes no use of international benchmarks or TSLRIC models to price fixed line services.

The certainty provided by having the principles in legislation does create some level of certainty for all parties regarding the approach the NZCC will use to set access prices. However, it has the offsetting effect of also preventing the use of other approaches that might come to be viewed as more sensible over time. It also limits the ability of the NZCC to adjust its pricing approach as new market developments (and learning) occur. We understand that the New Zealand Government is now looking to change its approach so as not to dissuade

10 These problems are described in further detail in Frontier Economics, *Economics of Transmission Capacity services: Report for the ACCC*, June 2009, available at http://www.accc.gov.au/system/files/Frontier%20Report.pdf.

investment in new networks that will ultimately displace existing copper networks.[11]

11 NZ Ministry of Business, Innovation and Employment, *Review of the Telecommunications Act 2001*, Discussion document, August 2013.

4 Price discrimination and NBN Co

4.1 Price discrimination provisions

Under sections 152AXC and 152AXD of the Act, NBN Co must not discriminate between access seekers. The effect of this requirement is that terms and conditions of all services provided by NBN Co must be public and equally available to all access seekers, so that all services are offered on an open access and equivalent basis. Other operators of superfast networks (as defined in Parts 7 and 8 of the *Telecommunications Act 1997*) are subject to similar rules.

The ACCC has published guidelines on the operation of the non-discrimination provisions.[12]

In 2011, the Parliament rejected an alternative approach to allow NBN Co to discriminate where this would have aided efficiency, provided that all access seekers with like circumstances had an equal opportunity to benefit from the discrimination.

The non-discrimination provisions provide for a blanket prohibition on direct and indirect discrimination between access seekers, other than in the specific circumstance where there are reasonable grounds to believe that the access seeker will fail to comply with terms and conditions of supply.

4.2 The Panel's questions

The Panel requests:

> …views on whether the non-discrimination provisions applying to NBN Co and superfast network operators should be retained, relaxed or repealed.

The Panel notes that, arguably, the price discrimination provisions have curbed NBN Co's ability to take advantage of efficiencies, such as offering different terms to access seekers depending on complementary investments or commitments that reduce NBN Co's own costs.

The Panel also notes that:

- Structural separation should reduce the need for distinct price discrimination provisions and
- Vesting discretionary powers in the regulator to approve certain kinds of discrimination would not be desirable unless it yielded significant net benefits.

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12 ACCC, *Part XIC non-discrimination guidelines: ACCC explanatory material relating to the Part XIC anti-discrimination provisions and the form of Statements of Differences*, available at www.accc.gov.au

To develop an appropriate approach to limitations applied to price discrimination, we first need to assess:

- Whether NBN Co has incentives to discriminate in anti-competitive ways
- If it does, whether the best way to prevent this is a blanket prohibition or a targeted prohibition which gives the regulator a discretionary role.

In the following sections, we discuss incentives to discriminate anti-competitively in an environment where NBN Co remains vertically separated. We then analyse targeted prohibition regimes.

4.3 Does NBN Co have incentives to discriminate in anti-competitive ways?

The economic literature on price discrimination is large and diverse, but much of it is of limited value to assessing price discrimination in *input* markets rather than final goods markets. Nonetheless, the limited literature[13] offers two important lessons:

- Discrimination that does not affect competitive positioning of firms offers considerable potential benefit in terms of pricing efficiency (e.g. through using two part tariffs or Ramsey pricing), but with minimal downside (some consumers might pay more than they otherwise would under no discrimination) so long as NBN Co's returns are regulated.
- There is a general presumption that a (separated) monopoly will have little interest in favouring particular competitors. Where the monopolist appears to do so, it will be difficult to distinguish between discrimination that harms certain competitors from discrimination that harms competition in downstream markets. Price discrimination will put some firms at a competitive disadvantage, but price discrimination in inputs can lead to lower prices overall (and is pro-competitive).

The literature that identifies detriments from discrimination in input markets commonly assumes that the upstream firm engaging in discrimination can use this as a tool to extract monopoly rents, while downstream firms can constrain the upstream firm by threatening to integrate or otherwise bypass the monopoly.[14] The first condition seems unlikely to apply to NBN Co given its regulatory constraints, while the second is the subject of some conjecture. If neither condition holds, we would conclude that:

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13 Starting with Michael L. Katz, "The Welfare Effects of Third-Degree Price Discrimination in Intermediate Good Markets", *The American Economic Review*, Vol. 77, No. 1 (Mar., 1987), pp. 154-167

14 Ibid.

- NBN Co would be unlikely to engage in price discrimination that benefits particular competitors; and
- Even if NBN Co does, it is likely to be offset by benefits deriving from greater output and end-user welfare.

Having said this, if existing infrastructure owners are able to establish some leverage over NBN Co (by either maintaining outside supply options, or doing a deal with NBN Co to sell these assets in return for favourable access terms), then we find that there would be greater reason for concern about price discrimination.

4.3.1 NBN Co's deals with infrastructure owners may raise concerns

The economic literature on price discrimination in input markets suggests that lower input prices might be offered to larger retailers to dissuade them from integrating upstream or otherwise substituting to other suppliers.[15] This can have deleterious effects on competition in the downstream market.

Are these concerns relevant to NBN Co's supply of wholesale services to access seekers?

If NBN Co obtained control of all relevant fixed line assets (for example, by buying them outright) then the prospects of these kinds of effects might be minimal. However, the threat of upstream integration or substitution towards other suppliers will look more credible if (a) other infrastructure suppliers maintain control over key assets which could be used to provide competitive wholesale services, *and* (b) integration or substitution is not prevented by non-compete agreements or other government legislation on the supply of competing services.

In such circumstances, it might be concerning if infrastructure owners were able to use their superior leverage to obtain a better deal from NBN Co than other access seekers.

NBN Co is likely to be better off if it can agree deals with infrastructure owners to buy their assets rather than compete with them, and this gives these infrastructure owners some bargaining power. For example, Telstra may be willing to sell or lease assets from its copper and HFC networks at a low price if it could strike a deal with NBN Co to gain a competitive advantage over other access seekers. This form of discrimination could potentially distort competition and reduce efficiency.

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15 Inderst and Shaffer, "Market power, Price discrimination and Allocative Efficiency in Intermediate-Goods Markets", *RAND Journal of Economics*, 2009, Vol 40 No. 4

In other words, NBN Co offering lower prices based on genuine economic efficiencies in supply is defensible and favourable to end-users. But if these lower prices are based on leveraging favourable negotiating positions, it would be concerning if new entrants and firms without existing infrastructure could not compete effectively. For completeness, we note that the existing deals with Telstra and Optus do not raise obvious concerns; however, our understanding is that these were struck in the expectation that the price discrimination provisions would be in force. There may be some concerns in a situation where the deals are renegotiated without strong controls on discrimination.

The concerns of access seekers with significant existing infrastructure are likely to be particularly heightened where they themselves are expected to make significant complementary investments in networks and retail functions. Uncertainty over whether other access seekers might be able to strike advantageous deals could lessen these complementary investments.

4.4 Discretionary price discrimination provisions are inherently problematic to enforce

Any rule which restricts a firm's actions is likely to create some form of regulatory burden on the ACCC, which will have to enforce the rule; on NBN Co, which will have to abide by it; and on NBN Co's customers, who may seek to exploit it.

As an example, consider a rule that proscribed price discrimination where this could affect competition, but allowed one or more exceptions to that rule. Obvious exceptions to the rule might be a 'cost justification' or 'meeting competition' defence. These kinds of exceptions seemed to have been highly problematic in the context of the Robinson-Patman Act (US)[16] and past Australian laws proscribing price discrimination (including the telecommunications specific provisions in the old *Telecommunications Act 1991*). That is, such a rule is likely to lead to:

- increased compliance costs for NBN Co
- a burden on the ACCC to investigate particular contracts or prices charged where these are discriminatory
- a large number of inquiries / requests for investigations by customers of NBNCo.

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16 O'Brien and Shaffer call the cost justification defence in the Act 'a mirage', given the inherent difficultly in determining economic costs and arbitrariness in allocating them to individual products. O'Brien and Shaffer, "The Welfare Effects of Forbidding Discriminatory Discounts: A Secondary Line Analysis of Robinson-Patman", in *Journal of Law, Economics and Organization*, 1994, Vol. 10, No. 2.

On top of regulatory burdens are regulatory costs – that is, costs arising from incorrect decisions by the ACCC. These costs are likely to derive from two sources:

- where price discrimination is rejected but the net effects of that discrimination would be to promote the LTIE (Type I error)
- where price discrimination is allowed but the net effect would be against the LTIE (Type II error).

There is also a relationship between the regulatory burdens and the costs of errors:

- the stricter is the rule (i.e. no discrimination at all), the lower will be the regulatory burden but the higher will be the probability of Type I regulatory errors.
- the greater the complexity of the rule (i.e. discrimination allowed where cost justified), the higher will be the regulatory burden, the higher will be the probability of Type II regulatory errors, but the lower will be the probability of Type I regulatory errors.

Certainty is also relevant here, as stricter rules tend to offer greater certainty. Removing the price discrimination rules would offer more certainty than a discretionary rule, but would appear to offer access seekers less certainty about the prevalence of price discrimination.

These estimated effects are summarised in Table 1.

Table 1: Price discrimination rules and kinds of error

Rule	Type I error Efficient price discrimination is blocked	Type II error Anti-competitive price discrimination is allowed	Regulatory and compliance costs	Certainty
Ban on all price discrimination	Moderate – High	Low	Low	High
Allow discretionary rule (e.g. cost justification)	Low – Moderate	Low – Moderate	High	Low
Allow price discrimination subject to general competition provisions	Low	Moderate – High	Low	Moderate

Source: Frontier Economics

We summarise these findings as follows:

- provisions that ban all forms of price discrimination are subject to Type I errors, but not Type II errors.
- provisions that allow some kinds of price discrimination address the potential for Type I errors, but raise the costs of assessing whether a Type II or Type I error is occurring.
- Allowing reliance on general competition laws facilitates a higher probability of Type II errors, but has low probability of Type I errors.

4.5 On balance, the current prohibitions should remain

We agree with the Panel that with NBN Co vertically separated, the majority of concerns around price discrimination are significantly lessened. Although it will very likely have the *ability*, NBN Co's *incentive* to price discriminate in ways that will adversely affect competition in downstream markets may not be strong. However, these incentives might arise if existing infrastructure owners can leverage their positions to induce favourable access deals, and there is a significant likelihood that such agreements would not be pro-competitive. With the NBN Co deals to be renegotiated as a result of revisions to NBN policy, there is a risk the removal of price discrimination provisions could have detrimental effects.

Based on our analysis in the preceding two sections, there seem to be three policy options:

- to disallow all forms of price discrimination where it affects access seekers who are likely to be competitors, meaning that 'like for like' terms must be offered (unless this can be justified by cost differences)
- to disallow all forms of price discrimination that is directed at access seekers (the current approach)
- to forbear from *ex ante* regulation and allow all forms of price discrimination, and instead rely on enforcement of rules preventing anti-competitive discrimination under the general anti-competitive conduct provisions (or telecommunications-specific provisions) of the CCA.

Any rules that seek to proscribe certain forms of price discrimination will likely create a significant regulatory burden and increase the probability of regulatory error. In that regard, simple rules are more likely to have lower compliance costs and be enforceable, but come at the risk of increasing some forms of regulatory error.

Equally, reliance on the anti-competitive conduct provisions of the CCA is unlikely to be an efficient regulatory response. Section 46 processes are drawn out and cumbersome (with multiple rounds of appeal likely), and significant

uncertainties remain about the meaning and application of key provisions in the test (particularly the 'taking advantage' limb). The ACCC has only rarely resorted to Part XIB cases, for similar reasons. Perhaps it is appropriate that it is difficult to pursue and prevent anti-competitive conduct – on the basis that it is simply not that prevalent in the economy. But even if that is true, this is not likely to deliver a great deal of certainty to access seekers.

In the absence of any significant evidence about 'lost opportunities' for efficient discrimination, we favour maintaining the current provisions. Given that our primary concern is with the specific nature of the deals that are struck between infrastructure owners and NBN Co, it is possible that there would be some benefit in imposing a time limit on the provisions, at which point they would be reviewed or fall away (sunset). This would need to be long enough that it would mitigate concerns about the connections between any deals and the access prices or other terms that are offered.

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